Implications of the Cook Islands' Graduation from Development Assistance Committee (DAC) Eligibility

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Executive summary

- Apart from any possible effects on New Zealand's aid programme, DAC graduation has very limited implications for the Cook Islands. In terms of financial assistance, around half of the economy's aid now comes from sources that appear insensitive to DAC graduation, and this will increase with the rising donor profile of China and international climate change agencies such as GEF.
- Of the DAC-member-state funding from donors other than New Zealand, the large capital sums currently flowing from the EU will drop steeply in any case as the infrastructure projects they support are completed, and the EU's longer-run role seems likely to be a minor one. The same is true of Japan.
- Possibly access to some training programmes and technical assistance provided by international agencies may be reduced, but this remains to be tested in practice.
- A base tier of aid, comprising small aid grants to front-line government agencies from a wide range of donors which are unconcerned with the issue of DAC graduation, provides between $10 million and $20 million per year, and is expected to continue post-graduation.
- A second tier is budget support, which provides a further $10 million per year. This is not explicitly guaranteed to continue beyond 2018, but neither is it explicitly guaranteed to be discontinued. A reasonable response to this uncertainty would be for the Cook Islands Government to establish a buffer-fund arrangement of some sort. New Zealand accounts for $8 million of this tier and the EU for $2 million.
- Large capital grants to fund key infrastructure investments make up the top tier of aid. Funding for the key projects identified in the 2015 Infrastructure Plan will have been committed prior to graduation, though the actual spending will continue beyond it. Capital needs beyond 2021 will be smaller and less "lumpy", and could be within the fiscal capacity of the Cook Islands Government if (i) the fiscal responsibility limit on tax revenues can be relaxed somewhat and (ii) funding from non-DAC donors continues to increase.
- The impact of graduation on the cost of borrowing is not a serious issue. The Cook Islands already has access to more loan finance than it can use within its fiscal-responsibility ceiling, which requires it to keep net debt below 35% of GDP. Cost is not a constraint on borrowing, debt service is manageable so long as the debt ceiling holds, and the study found no evidence that the cost of loan finance will increase post-graduation.
- Donors such as ADB tend to conceptualise development in terms of a crowding-out model that may not be sufficiently attuned to the particular circumstances of a shared-citizenship economy. Whether there is now a serious crowding-out risk in the Cook Islands is unclear.
- The national accounts and balance of payments statistics point to an unidentified outflow of up to $100 million per year from the economy. This is likely to be after-tax private-sector profits and land rents retained offshore rather than invested back into

the Cook Islands economy. Capturing a greater share of this surplus would be the key to increased fiscal self-sufficiency and reduced reliance on aid.

- The company tax rate is low relative to that in New Zealand and consideration could be given to raising it.
- There is an immediate need to strengthen the Cook Islands national accounts, with particular emphasis on (i) producing more comprehensive balance of payments accounts, with special attention paid to the primary and secondary income components of the current account; (ii) constructing a Tourism Satellite Account to trace more accurately the factor incomes being generated in the core of the economy's private sector; and (iii) producing an authoritative figure for GNI per capita, with a view to finding out whether graduation from the DAC system may be premature given that it uses GDP as a proxy for GNI.
- A change that would relieve fiscal pressure and free up resources for the financially stressed education, health and social impact sectors would be termination or privatisation of the $12 million annual subsidy to Air New Zealand. If the subsidy is to continue a case can be made for having it paid for by the private tourism sector which is the direct beneficiary.

1. Introduction

In 2017 it is expected that the OECD's Development Advisory Committee (DAC) will judge the Cook Islands to have exceeded, for over three years, the high-income country threshold set by the World Bank. Under the DAC rules, once the Cook Islands has "graduated" to high income status, aid provided to it by external donors will no longer be accorded the status of "Official Development Assistance" (ODA[1]) in the donor league tables produced by the DAC. Whether this leads to any change in donor willingness to provide aid will depend firstly on whether donors are DAC members (for non-DAC members the graduation will be irrelevant); and secondly on the motivations that lie behind the giving of aid by particular donors that are DAC members (or reported in the DAC statistics), which will determine whether or not their future funding decisions are sensitive to the fact of a recipient economy's graduation.

I have been asked by the Ministry of Foreign Affairs and Trade (MFAT) and the Cook Islands Government (CIG) to evaluate the implications for the Cook Islands of its anticipated graduation from Upper Middle Income status to High Income status. The goal specified for this project is "to assist the Cook Islands to effectively and efficiently manage the fiscal transition to a post-ODA environment." Central to the investigation, therefore, is the question whether DAC graduation implies any change from the status quo in terms of the Cook Islands' access to external funding. If so, there will be obvious fiscal consequences to be addressed. If not, the transition might be purely terminological – a change in the descriptors applied to ongoing flows of financial assistance, but with no clear economic impact.

Particular issues to be addressed, as set out in the Terms of Reference for this study, are as follows:

- Describe the current (baseline) and projected levels of financial and technical support received and forecast by the Cook Islands;
- Assess what the implications of [DAC] ODA graduation may be for the Cook Islands, in terms of accessing financial and technical support;
- Assess whether a loss of ODA support to the Cook Islands could cause economic set backs, and what these setbacks might be;
- Assess whether graduation could result in a project or service delivery shortfall within the Cook Islands economy;
- Assess, post-graduation, whether the Cook Islands' cost of borrowing will increase (if concessional lending terms become less available), and whether perceptions of the Cook Islands' debt servicing capability are likely to change;

[1] Throughout this report the term "ODA" has been used, as in the Cook Islands Government's budget documentation which was a main source for this report, to refer to all grant aid received from official external sources. This is a wider definition than that generally used by MFAT, which restricts ODA to DAC-reportable aid flows.

- Identify key revenue risks and opportunities (e.g. limited resources, reliance on tourism, debt burden, climate change finance and New Zealand assistance);
- Recommend policy/legislation options for mitigating risks and maximising opportunities (e.g. tax reform, sovereign wealth funds etc.);
- Consider options and recommendations for a 'smooth transition' that minimises disruption to the economy; and
- Consider any other economic analysis and assessment of implications and consequences of potential graduation.

A number of these issues, and particularly the third bullet point, were addressed in the 2015 evaluation of New Zealand's country programme in the Cook Islands by Adam Smith International. That report concluded that external aid has been fundamental to achieving the relatively high living standards observed in the Cook Islands, that continued external support will be required to sustain those achievements, and that quite apart from DAC graduation, the winding-down from the current high level of aid inflows in the 2020s, once the current generation of large infrastructure investment projects are completed, could present some risk of deflationary macroeconomic effects.[2]

The present report summarises the findings from a desk study of relevant documentation, supplemented by a two-week period of in-country interviews in Rarotonga during August-September 2016. Heavy reliance is placed on the documents produced by the Cook Islands Ministry of Finance and Economic Management (MFEM) in the course of its annual budget round, and on the official economic and demographic statistics posted on the MFEM website or published in earlier years by the Cook Islands Statistics Office (CISO). These documents – particularly the three-volume annual Budget - contain extensive fiscal and economic information and projections, and commentary on the continually-unfolding picture of the makeup and delivery of the flows of external aid. In addition, use has been made of other source material, including previous consultancy reports on the Cook Islands economy commissioned by MFAT and the Asian Development Bank (ADB), online statistical databases maintained by ADB, the United Nations Statistical Division, the World Bank and Statistics New Zealand, and the academic literature on small island developing economies.

An unexpected issue that arose from a preliminary review of the Cook Islands national accounts and balance of payments statistics was whether a DAC decision to graduate the Cook Islands in 2017 might in fact be premature. This is addressed in the next section.

2. GNI, GDP, the balance of payments and the graduation threshold

In the World Bank's classification of countries by income per capita, a country is considered to move from Upper Middle Income to High Income status when its per capita Gross National Income (GNI) exceeds a level equivalent to US$6,000 at 1987 prices. Using the international Special Drawing Rights (SDR) deflator, the World Bank escalates all its income-

[2] Adam Smith International 2015.

group thresholds to new values in current US dollars at July 1 each year, and then ranks countries against these thresholds on the basis of their GNI per capita in the previous year[3]. As of 1 July 2016, low-income economies were defined as those with a GNI per capita, calculated using the World Bank Atlas method, of $1,025 or less in 2015; lower middle-income economies were those with a GNI per capita between $1,026 and $4,035; upper middle-income economies were those with a GNI per capita between $4,036 and $12,475; and high-income economies were those with a GNI per capita of $12,476 or more[4].

The original high-income threshold was set in 1989 to distinguish so-called "industrial economies" from the rest[5]. Three decades on, an "industrial" economy is no longer the necessary end-point of a development process. For many small island economies the issue is to sustain non-industrial economies at high standards of living, in a world of increasing labour mobility[6]. A tourism economy such as that of the Cook Islands is not "industrial" in the traditional sense, and has no prospect of moving in that direction. Its prosperity hinges crucially on, and is tightly linked to, the course of economic events in the outside world, and its main output, tourism services, cannot be redirected to support local material living standards in the event of disappearance of its external customer base. "Self-sufficiency" is a difficult concept to apply in this situation; it certainly cannot be used in the sense of ability to fall back on an autonomous local economic base as insurance against a global downturn.

Apart from qualitative issues with the graduation methodology[7], there is an important measurement problem. All countries in the World Bank classification produce national accounts which contain an annual number for Gross Domestic Product (GDP), but many of them (especially the smaller economies) do not calculate GNI. The usual practice of the World Bank and the OECD in these cases is to use GDP as their proxy for GNI. It is on the basis of this proxy measure that the Cook Islands faces graduation in 2017.

The numbers likely to be used to support graduation are shown in Table 2.1, which compares Cook Islands GDP per capita with the World Bank threshold level over the past three decades, first in current US dollars and then in current New Zealand dollars to facilitate comparison with other data analysed below. An additional column in Table 2.1 shows the GDP per resident, calculated using Cook Islands Statistical Office estimates of resident population from 1992 to 2014. Figure 2.1 graphs the data.

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3 World Bank, *Why use GNI per capita to classify economies into income groupings?* https://datahelpdesk.worldbank.org/knowledgebase/articles/378831-why-use-gni-per-capita-to-classify-economies-into, accessed July 2016.

4 "New country classifications by income level", 1 July 2016, http://blogs.worldbank.org/opendata/category/tags/news accessed 15 September 2016.

5 Will Price comment 7 December 2013, posted on http://blogs.worldbank.org/opendata/reviewing-world-bank-s-analytical-country-classification-update .

6 Bertram and Poirine 2007.

7 For a sample of the extensive debate over the World Bank rankings and the DAC graduation methodology see, e.g., Fantom and Serajuddim 2016, Nielsen 2011, Kenny 2014, World Bank 2012, Sedemund 2015, DAC 2014.

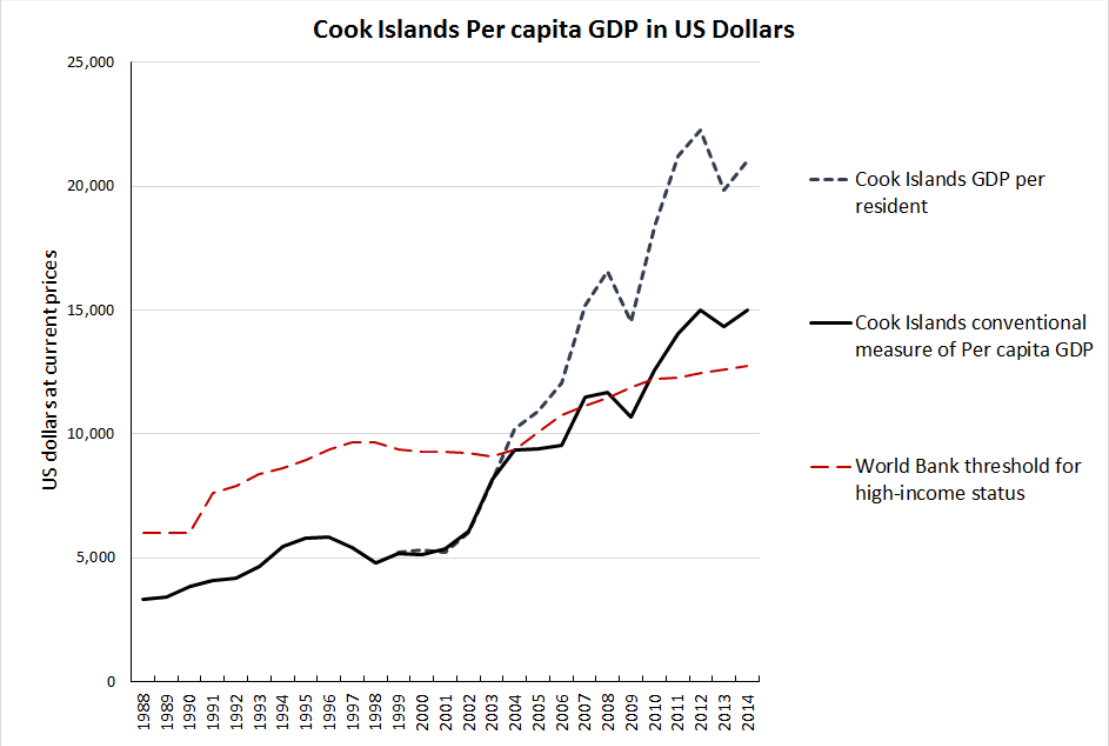
Table 2.1: Cook Islands GDP per capita compared with World Bank graduation threshold

	1	2	3	4	5	6	7
	World Bank High Income threshold US Dollars per capita	Cook Islands GDP per capita in US Dollars	Ratio (% of threshold) 1 ÷ 2	Exchange rate, NZD per USD	World Bank High Income threshold in NZ Dollars	Cook Islands GDP per capita in NZ Dollars	Cook Islands GDP per resident in NZ Dollars
1988	6,000	3,331	56%	1.53	9,158	5,085	
1989	6,000	3,413	57%	1.67	10,033	5,707	
1990	6,000	3,832	64%	1.68	10,057	6,423	
1991	7,620	4,086	54%	1.73	13,209	7,083	
1992	7,910	4,186	53%	1.86	14,727	7,793	7,975
1993	8,355	4,630	55%	1.85	15,461	8,568	8,965
1994	8,625	5,452	63%	1.69	14,546	9,195	9,120
1995	8,955	5,786	65%	1.52	13,646	8,818	8,772
1996	9,385	5,854	62%	1.45	13,654	8,517	8,265
1997	9,645	5,427	56%	1.51	14,587	8,208	8,486
1998	9,655	4,780	50%	1.87	18,038	8,930	9,580
1999	9,360	5,149	55%	1.89	17,687	9,730	11,106
2000	9,265	5,140	55%	2.20	20,394	11,315	13,446
2001	9,265	5,346	58%	2.38	22,039	12,716	16,236
2002	9,205	6,074	66%	2.16	19,903	13,132	16,245
2003	9,075	8,174	90%	1.72	15,628	14,076	18,927
2004	9,385	9,358	100%	1.51	14,159	14,118	19,946
2005	10,065	9,411	93%	1.42	14,295	13,366	18,789
2006	10,725	9,557	89%	1.54	16,539	14,737	19,442
2007	11,115	11,478	103%	1.36	15,124	15,617	20,956
2008	11,455	11,661	102%	1.42	16,297	16,591	23,225
2009	11,905	10,653	89%	1.60	19,058	17,054	25,842
2010	12,195	12,579	103%	1.39	16,925	17,457	29,756
2011	12,275	14,029	114%	1.27	15,538	17,759	24,653
2012	12,475	14,981	120%	1.23	15,398	18,491	26,531
2013	12,615	14,317	113%	1.22	15,383	17,458	25,532
2014	12,745	15,003	118%	1.21	15,363	18,085	27,559
2015	12,735			1.47	18,668		
2016	12,475			1.50	18,668		

Sources: Column 1 from http://siteresources.worldbank.org/DATASTATISTICS/Resources/OGHIST.xls and Column 5 is this series converted to NZ dollars using the annual average exchange rate in Column 4.
Column 2 from http://unstats.un.org/unsd/snaama/selbasicFast.asp; Column 6 calculated from the same UN SAA website's series for GDP in current NZD and population. Both are for calendar years according to http://unstats.un.org/unsd/snaama/notes.asp.
Column 4 1988-2014 from http://unstats.un.org/unsd/snaama/selbasicFast.asp, reported as IMF average rate for the year; 2015 and 2016 are calendar-year averages calculated from IMF International Financial Statistics database at http://data.imf.org/?sk=5dabaff2-c5ad-4d27-a175-1253419c02d1 .
Column 7 is the same GDP series as for Column 6, but calculated using the Cook Islands Statistics Office estimate of resident population from http://www.mfem.gov.ck/statistics/social-statistics/vital-stats-pop-est accessed 27 July 2016.

If GDP is a good proxy for GNI in the Cook Islands case then Table 2.1, and Figure 2.1 based on it, indicate that the economy has been over the graduation threshold since 2010 using census population, and since 2003 if resident population rather than total population is used as denominator (an approach which, however intuitively appealing in tourism-driven economies, has never been used by the World Bank or the DAC so far as could be determined on the course of this study).

Figure 2.1



Using GDP per capita as the proxy for GNI can be a safe procedure for DAC graduation purposes only so long as the two measures do not diverge much (or if GNI is above GDP, in which case the case for graduation will be strengthened by using the correct indicator). If GNI is significantly lower than GDP, the use of the latter as a proxy for national income could result in premature graduation.

GNI was introduced into national accounting terminology in the 1993 System of National Accounts, replacing the identically-defined concept of Gross National Product (GNP). The definition of GNI is as follows[8]

> **GNI (gross national income)** is gross domestic product (GDP) plus net receipts of primary income (employee compensation and investment income) from abroad.

The distinction between GDP and GNI thus hinges on whether there are large net flows of primary income[9] across a country's border. To identify situations where this is the case, the

[8] https://www.gfmag.com/global-data/glossary/gdp-gni-definitions; see also OECD, "Glossary of statistical terms", https://stats.oecd.org/glossary/detail.asp?ID=1176.

[9] Primary income is income directly resulting from participation in the production process. In the current IMF balance of payments methodology BPM6, primary income comprises compensation of employees;

first step is to see whether trade in goods and services is in balance. A deficit on goods and services will mean that some source of funds other than export earnings is being drawn on to maintain equilibrium in the overall balance of payments; this can mean either large inflows of current transfers from abroad (dividends and interest on assets held abroad, remittances from wages earned abroad, and various other unrequited transfers) or large-scale capital inflows (overseas borrowing or foreign direct investment). If there is no sign of rapid debt accumulation or rising foreign ownership of local assets, it would follow that the goods and services trade deficit is being covered by current inflows of primary and secondary income. If the former of these two is the balancing flow, the GNI will exceed GDP by the amount of the primary income surplus.

The converse applies if there is a large surplus on trade in goods and services, as is currently observed in the Cook Islands. In this case funds must be moving out of the economy, either as outward remittances of income, or as local savings being invested abroad.

No official GNI figures are currently available for the Cook Islands[10], but the following points about the balance of payments can serve to indicate possible orders of magnitude.

In 1983, the Cook Islands economy was running a deficit on its trade in goods and services equivalent to 45% of GDP, which appeared to be funded not by inflows of capital but rather by current (mainly secondary) income transfers: remittances and grant aid. This led to the development of the "MIRAB model" for small island economies[11], explaining how per capita national disposable income[12], and hence living standards, could be sustained at levels substantially above per capita GDP.

Between 1983 and today the Cook Islands has undergone an economic transformation. Since 2009 the national accounts show a surplus on goods and services trade equivalent to more than 20% of GDP.[13] The transformation is shown by the charts in Figures 2.2, 2.3 and 2.4.

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dividends; reinvested earnings; interest; investment income attributable to policyholders in insurance, standardized guarantees, and pension funds; rent; and some taxes and subsidies on products and production. Secondary income covers transfers that are not payment for factor services. A transfer is defined as "an entry that corresponds to the provision of a good, service, financial asset, or other nonproduced asset by an institutional unit to another institutional unit when there is no corresponding return of an item of economic value." Secondary income flows include grant aid to governments, income and wealth taxes collected by one jurisdiction from anther; social contributions and benefits; insurance premiums and claims, and miscellaneous other transfers (including remittances).

10 Asian Development Bank *Key Indicators for Asia and the Pacific 2015*, https://www.adb.org/publications/key-indicators-asia-and-pacific-2015, p.232 Table 2.3 for GNI shows a blank row for Cook Islands. The ADB Country Table for the Cook Islands at https://www.adb.org/sites/default/files/publication/175162/coo.pdf similarly has blank rows for "net factor income from abroad" and "GNI".

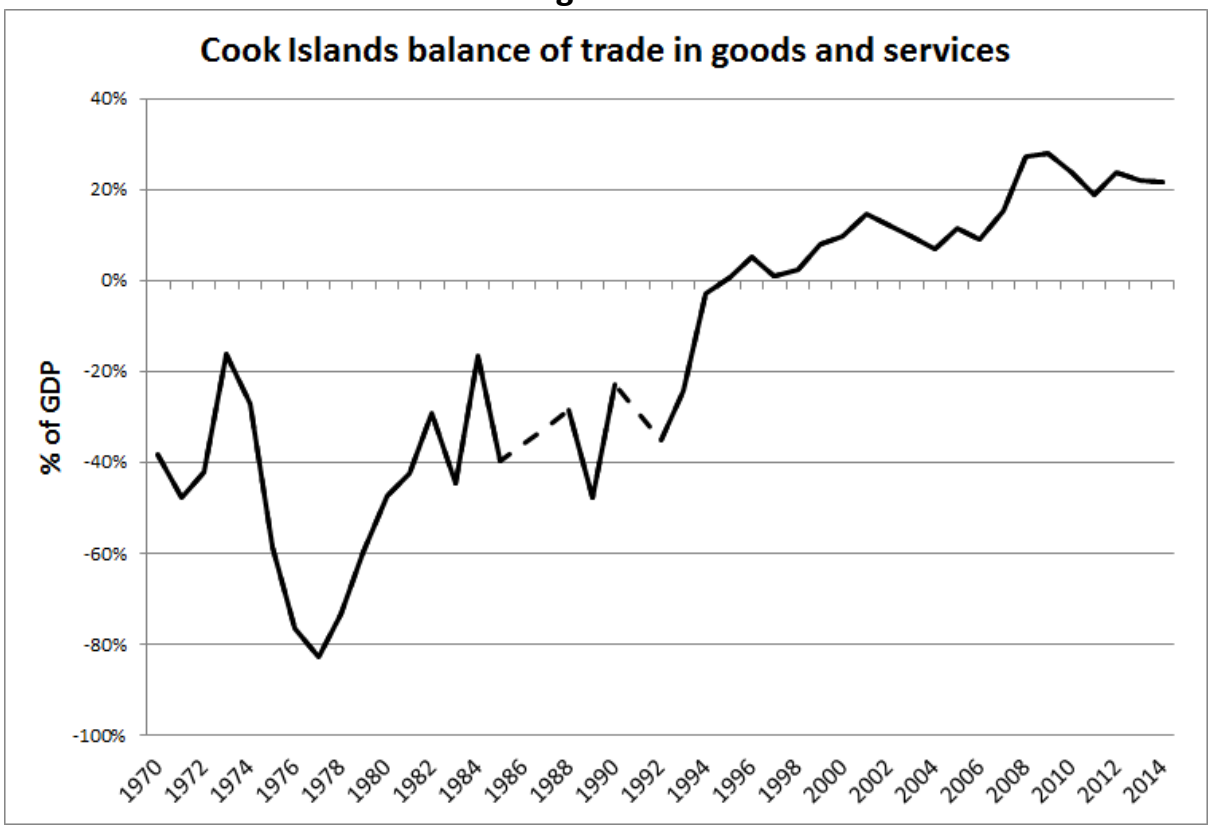
11 Bertram and Watters 1985.

12 The relevant measure of disposable income in that model was not GNI but Gross National Disposable Income, defined as GDP plus net primary and secondary income flows from abroad.

13 The current account (which includes aid inflows) "showed a surplus of equivalent to 37.3% of GDP in FY2016 and is projected to widen to 41.3% of GDP in FY2017" (Asian Development Bank *Pacific Economic Monitor* July 2016 p.5).

The story told by Figures 2.2 to 2.4 is straightforward. Prior to 2000 the Cook Islands economy ran a persistent deficit on goods and services trade; from 2000 on it has run an increasing surplus[14]. In real value terms (Figure 2.3) the rapid growth of services exports (primarily tourism) outpaced a static import volume. When measured relative to GDP (Figure 2.4) the services-sector export growth (the driver of GDP growth) was tightly tied to GDP, especially from 2000 on, while the ratio of imports to GDP fell steeply.

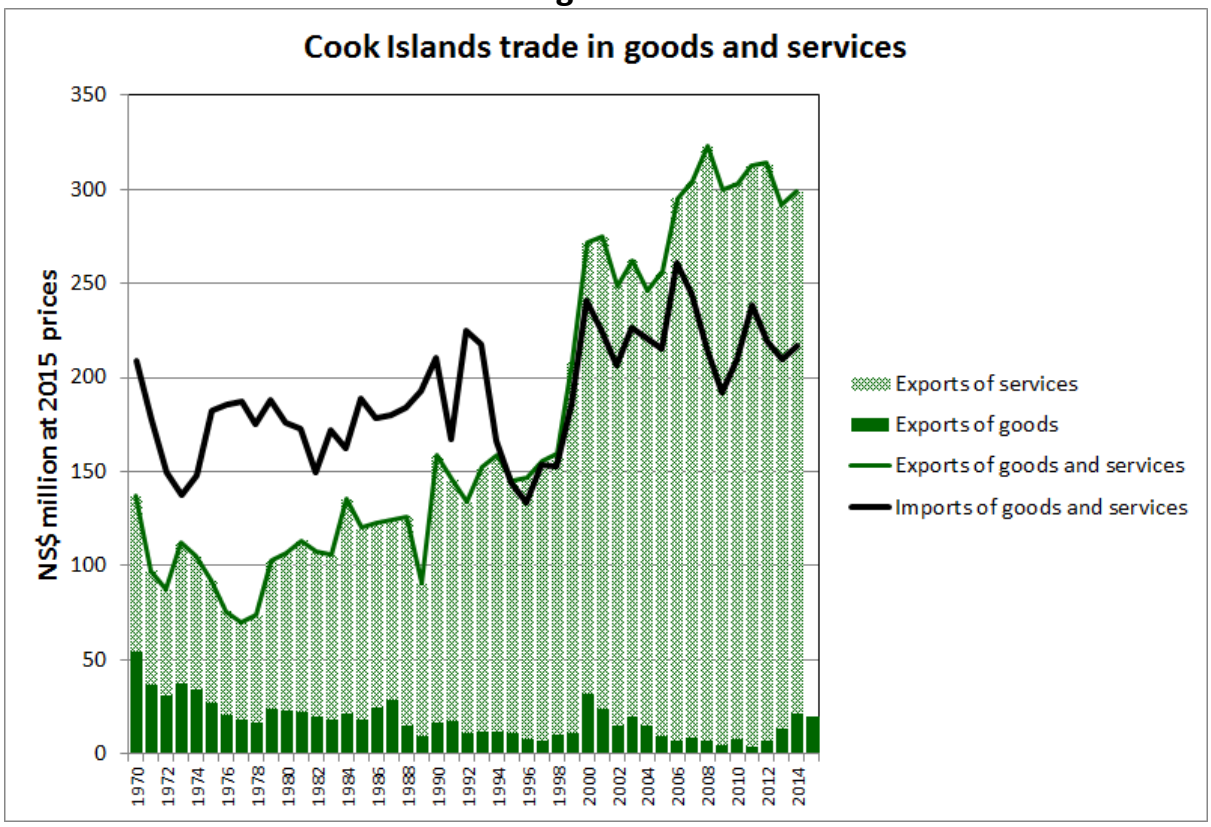
Figure 2.2



Sources: as for Figure 2.3 below. Data for 1986-87 and 1991-92 interpolated to remove artificial spikes in the UN national accounts data.

[14] The switch to a positive balance in 1996 was due initially to a sustained slump in imports 1995-99 during the restructuring and mass out-migration that followed the fiscal crisis of the mid-1990s. The real turning-point in the goods and services trade balance came about 2000.

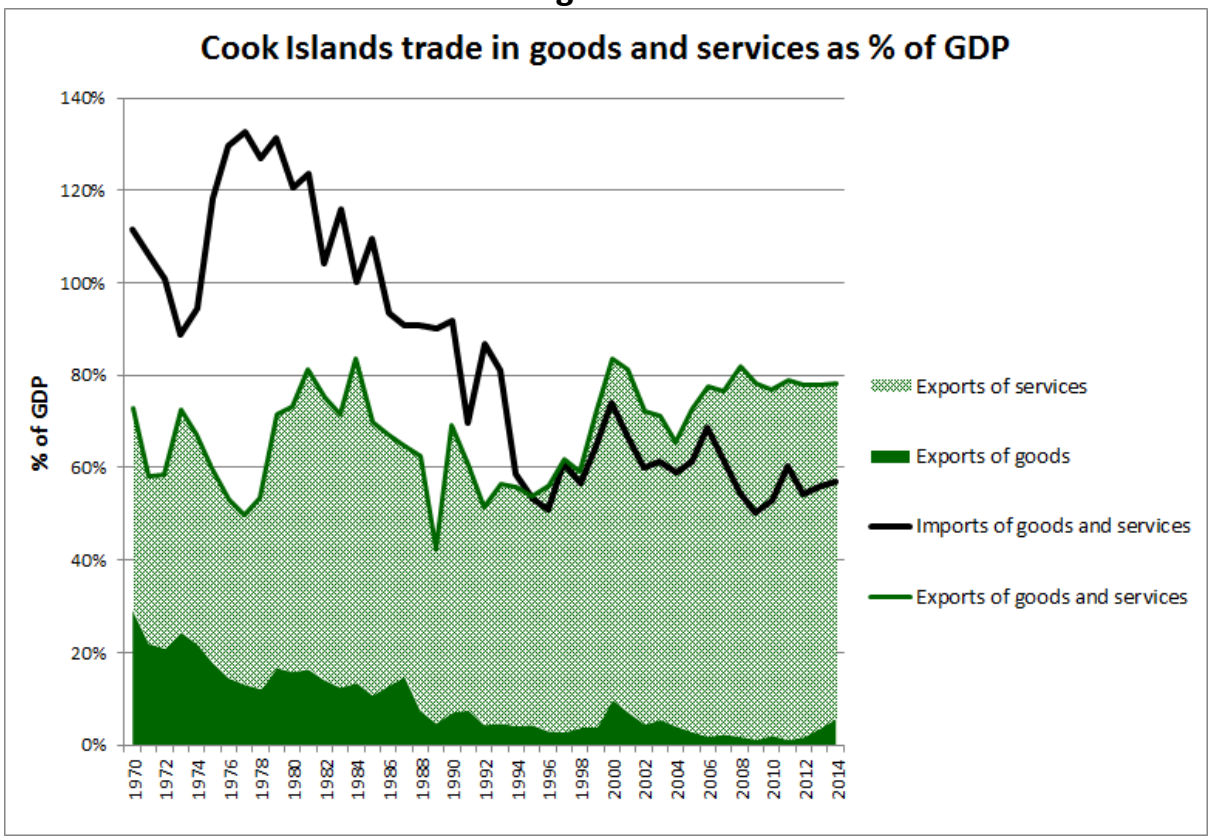
Figure 2.3



Sources: Goods and services exports and imports 1970-2014 from http://unstats.un.org/unsd/snaama/selbasicFast.asp "GDP by expenditure at current prices, national currency", downloaded 27 July 2016. Two unsubstantiated spikes in the UN series have been replaced by interpolated figures for 1986-87 and 1992.[15]
Goods exports and imports from *Cook Islands Annual Statistical Bulletin* various issues, and http://www.mfem.gov.ck/images/documents/Statistics_Docs/1.Economic/3.Merchandise-Trades/2016/Trade_Statistics_Tables_201601.xls downloaded 18 September 2016.
Services exports derived as a residual.
All series deflated to 2015 prices using deflated using the Cook Islands CPI, from *Annual Statistical Bulletin 2010* Table 3.2 and http://www.mfem.gov.ck/images/documents/Statistics_Docs/1.Economic/2.Consumer-Price-Index/2016/CPI_Statistics_Tables_201601.xlsx downloaded 18 September2016.

[15] There are two 'spikes' in the UN data for goods and services exports, corresponding to the period of recovery from Cyclone Sally in 1987-87 and the brief debt-funded boom of 1991. It seems probable that in these two periods the SNA accounting procedures used by the UN Statistical Office to balance identities in its expenditure-based version of the Cook Islands national account may have inadvertently included large inflows of aid and debt funding in the estimate of services exports. It is not clear whether the UN data for other years is subject to the same problem of overstatement, but a comparison with the CISO balance of payments estimates for 2010-2014 suggests that the UNSNAA dataset is currently understating the true volume of services exports.

Figure 2.4



Sources: Trade data same sources as for Figure 3.1, divided by GDP from http://unstats.un.org/unsd/snaama/selbasicFast.asp downloaded 27 July 2016.

Unless evidence comes to light of large capital flows out of the economy, this indicates large outward remittances of income. Insofar as those remittances comprise primary rather than secondary income, they imply that GNI is now significantly lower than GDP – a complete turnaround from the situation three decades ago. From Table 2.1 above it can be seen that if outward primary-income transfers are sufficient to produce a gap between per capita GDP and GNI of the order of $2,000 (about 11%) then the economy would still be below the high-income graduation threshold, if the World Bank/DAC formula is applied to the actual GNI measure rather than the proxy GDP measure.

Table 2.2 sets out the official balance of payments statistics, adding a row "errors and omissions", that is required to balance the accounts overall. The aim of this errors and omissions figure is to estimate, for each year, the outward flow of funds from the private sector implied by the surplus on trade in goods and services (which is based on reliable figures[16]) once government transactions have been accounted for. The calculation takes the official estimate of the current account balance, and adds to this any net inflow of funds attributable to the government. The "errors and omissions" row is then the flow of funds required to bring the overall balance of payments to zero.

[16] The crucial data are those for tourism earnings. In the course of this research the CISO estimates were successfully replicated using data from the AUT Visitor Surveys.

Table 2.2 Balance of payments official statistics, $ million

		2010	2011	2012	2013	2014
1	Exports of goods and services	207	241	264	270	282.8
2	Imports of goods and services	-152	-168	-170	-171	-164
3	**Balance on commercial transactions**	**55**	**73**	**94**	**99**	**119**
4	International cooperation transfers (grant aid)	12.1	16.7	17.3	25.5	36.1
5	Compensation of employees and personal transfers, net (=remittances)	0.3	0.3	0.4	0.4	0.5
6	Investment income net	-10.1	-11.2	-10.3	-9.1	-10.1
7	Other income transfers (primary and secondary)	0.5	0.6	-3.4	-6.6	-4.6
8	Income balance as recorded in the statistics	2.8	6.4	4	10.2	21.9
9	**Current account balance**	**58.2**	**79.5**	**98.2**	**108.9**	**140.4**
10	Net balance of payments impact of Government financial transactions	-20.5	-16.8	-38.6	-42.1	*n.a.*
11	**Errors and omissions**	**-37.7**	**-62.7**	**-59.6**	**-66.8**	***-140.4***[1]
12	**Basic equilibrium balance of payments**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

1. *Includes public-sector as well as private-sector flows.*

Sources: Rows 1-9 from Cook Islands Statistical Office *Balance of Payments Statistics tables*, http://www.mfem.gov.ck/images/documents/Statistics_Docs/1.Economic/6.Balance-of-Payments/BoP_Tables_1_-_5.xlsx downloaded 5 September 2016.
Row 10 from *Cook Islands Government Finance Statistics 2008/09 to 2012/13*, http://www.mfem.gov.ck/images/documents/Statistics_Docs/1.Economic/4.Government-Finance-Statistics/Cook_Island_Government_Finance_Statistics_2009-2013.pdf table headed "Transactions in assets and liabilities". Figures for calendar years to match the balance of payments data are constructed by splitting the June-year GFS figures in half and then recombining them as calendar year estimates. The 2013 figure is estimated assuming a net government-sector outflow in fiscal year 2013/14 of $20 million.
Row 12 imposed by assumption; row 11 then calculated.

At present, the official balance of payments statistics have no financial or capital account, and no record of primary income outflows on a scale that could explain the surplus on trade in goods and services. There is no explicit official estimate of the extent to which operating surplus of enterprises in the dominant tourism sector may be retained offshore (which would effectively create a primary income outflow that might escape statistical capture), but it is not hard to uncover anecdotal evidence that many businesses operating in Rarotonga have their earnings paid into bank accounts located in New Zealand and transfer to the Cook Islands no more of these funds than is required to cover local operating expenses.

Unfortunately the government sector's international financing operations are not well reported for fiscal years after 2011-2012. The published Government Finance Statistics for 2008/9 to 2012/13 provide overseas cash transactions, with contributions to the National Superannuation Fund (NSF) in New Zealand evidently included in the total, and with a very large unaudited figure of $64 million net cash outflow in 2012/13, for which no explanation has been located. For fiscal year 2013/14 no information could be located apart from the

$10 million outflow of NSF contributions. Government Finance Statistics tables for the following two fiscal years cover only the core Government sector, not the consolidated public sector, but show only very small cross-border financial flows attributable to government.

Over the period 2010-2013, as the current account surplus rose from $58 million to $109 million, the Cook Islands Government's outward payments do not look sufficient to explain more than half of the widening gap, and for more recent years it seems probable that the Government's impact has been smaller. The jump in the officially reported current account, to a surplus of $140 million in 2014, is therefore attributable mainly to the private sector, suggesting that up to $100 million per year may now be leaving the economy through unrecorded private-sector financial transactions.

In a complete set of balance-of-payments statistics, this outflow would appear either as a primary income debit or as capital outflow (acquisition of overseas assets). Without more information it is impossible to say which classification would be conceptually appropriate. Only if the outflow is identified as primary income would it be relevant for the calculation of GNI.

The research required to produce an authoritative GNI figure lies beyond the scope and terms of reference for this project. The ongoing surplus on trade in goods and services of around $100 million annually[17] equates to $5,000 per capita or $7,000 per resident, which sets an upper limit on the amount by which GDP per capita may exceed GNI per capita. If just half of this goods and services surplus corresponds to unrecorded primary income transfers[18], then graduation would be in doubt, at least until incomes in the Cook Islands rise further.

Insofar as a deferral of graduation may be seen as desirable, there is an urgent need to develop a complete set of balance of payments accounts in sufficient detail to separate current outflows of funds from capital outflows.

Quite apart from the (essentially technical) graduation issue, the balance of payments statistics raise an important substantive issue regarding the economics of aid in the Cook Islands context. In national accounting terms, an economy's current account balance is a measure of the difference between its domestic saving and domestic investment – or put another way, the difference between income and expenditure. If the official current account row in Table 2.2 is correct[19], in which case the errors and omissions row in Table 2.2

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17 Cook Islands Statistics Office 2016b.

18 The balance of payments statistics currently show a (largely aid-driven) surplus on secondary income and a modest deficit on primary income, resulting in an official current account estimated surplus of $140 million. The issue raised in the text is how much of this estimated surplus is attributable to under-recording of primary income debits.

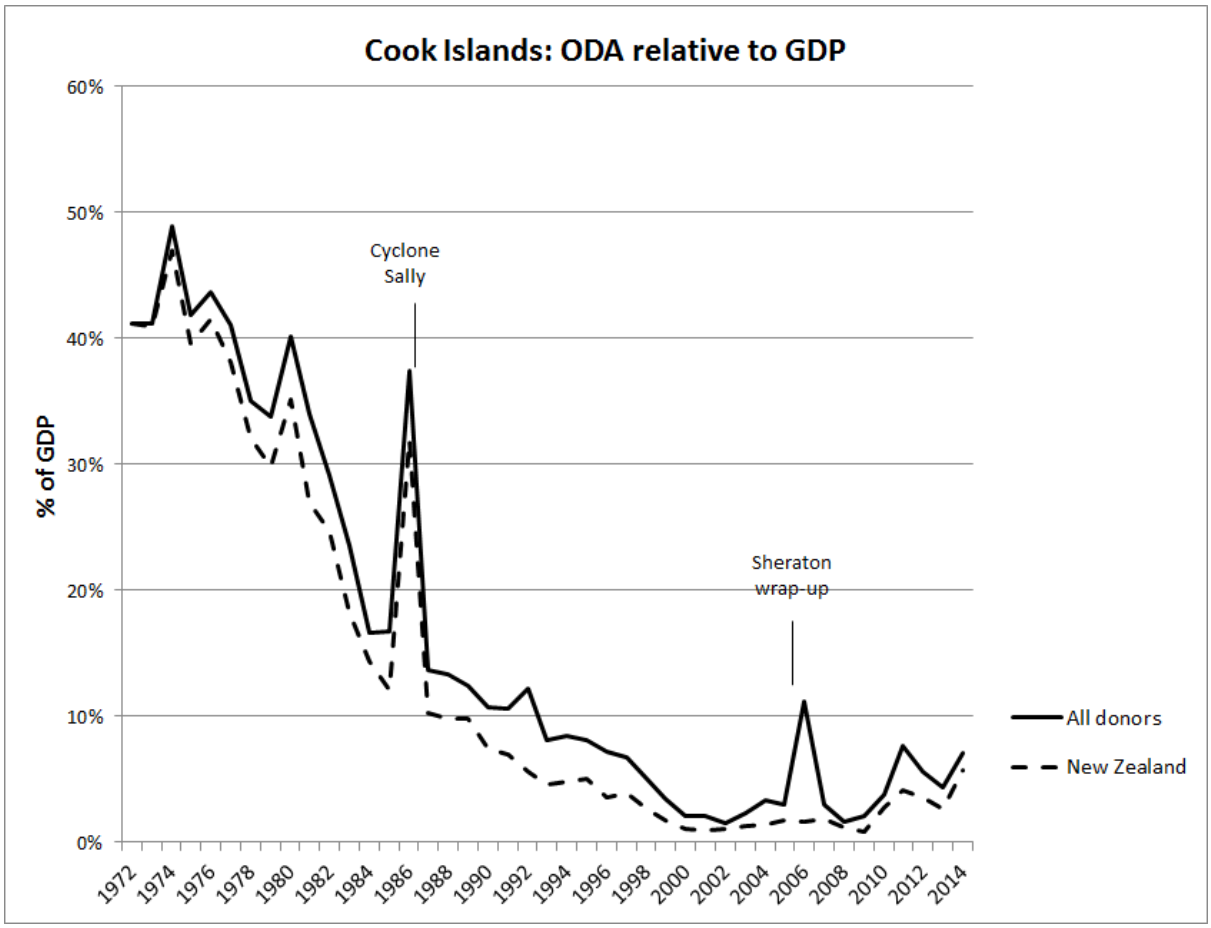
19 Estimates of the full current account, including primary and secondary income flows, are available from the CISO only for the years 2010-2014. Previous figures presented under the heading "current account" in, for example, ADB 2008 Table A2.20 p.202, are in fact only the commercial balance on goods and services trade, with no estimate of primary and secondary income.

would reflect saving rather than unreported primary income, the Cook Islands economy is saving up to $100 million more than it is investing. The Government accounts show negligible net public-sector saving, which means that the excess saving is almost entirely in the private sector.

If, on the other hand, the official figure for the current account balance is wrong and the errors and omissions in Table 2.2 represent unrecorded current income flows out of the economy, the implications for aid are essentially the same: a large economic surplus – profit and rents - is being accrued offshore, and not being saved and invested domestically.)

The annual inflow of grant aid to the Cook Islands public sector has fluctuated between $20 million and $40 million. The issue of why public sector investment needs to be financed from external aid rather than by tapping private-sector surpluses is addressed below.

Figure 2.5



Sources: ODA data from http://stats.oecd.org/qwids/ downloaded 25 July 2016, converted from USD using IMF average exchange rate from http://unstats.un.org/unsd/snaama/selbasicFast.asp, divided by GDP from http://unstats.un.org/unsd/snaama/selbasicFast.asp downloaded 27 July 2016.

Macroeconomic data such as those reviewed above would typically point to a radically reduced need for external aid – they are the hallmark of an economy that has (to a first approximation) grown out of aid dependence. Indeed as Figure 2.5 shows, the ratio of ODA

funding to the Cook Islands GDP has fallen dramatically over the past 45 years, from nearly 50% in 1974 to 2-3% 2000-2010 (with the exception of the 2006 spike when the Sheraton debt was extinguished and the Italian Government recorded some of this in its DAC statistics as "debt relief" ODA[20]). In the past five years the ODA/GDP ratio has risen back to around 5-7%, mainly due to large aid-funded capital-works programmes, but these should be coming to an end by the early-mid 2020s, suggesting that the longer-run aid requirement will be comfortably below 5% of GDP.

Graduation from DAC status will therefore put no more than 5%-of-GDP worth of external funding at risk. The stakes, in other words, are now much lower than would have been the case twenty or thirty years ago.

3. The Cook Islands economy's development pattern

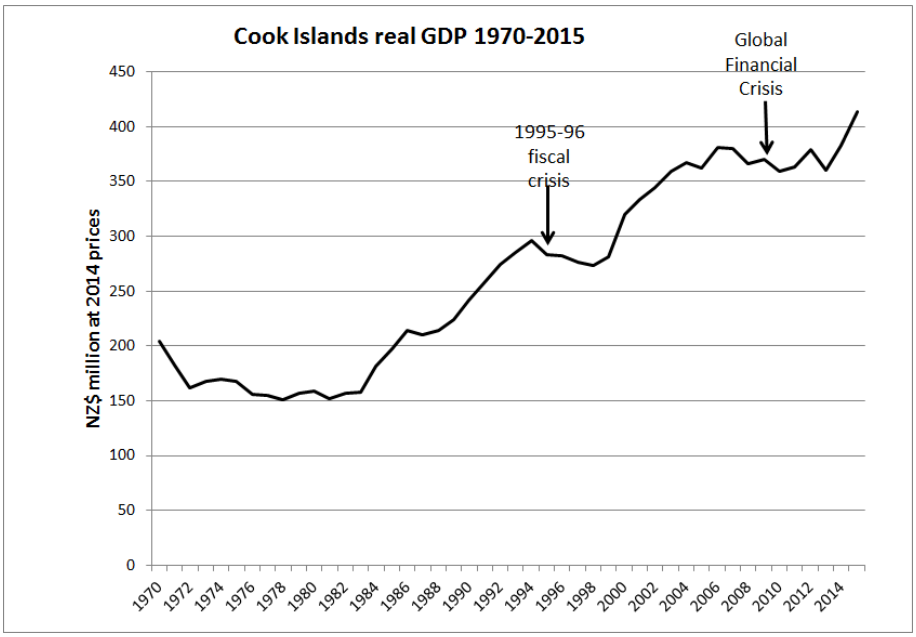
In terms of conventionally measured GDP, the recent growth history of the Cook Islands economy can be summed up in two charts. Figure 3.1 shows total GDP in real (2014) New Zealand dollars, and Figure 3.2 shows three population series: the UN estimate used in Figure 3.1, the more detailed figures at June of each year produced by the Cook Islands Statistics Office (CISO), and the CISO estimates of resident population (excluding temporary visitors such as tourists).

Figure 3.1 shows steady GDP growth through the 1980s and into the early 1990s, abruptly halted by the mid-1990s fiscal crisis which produced a severe recession from which there was a sharp recovery in 2000. There was then nearly a decade of sustained but slowing growth, reaching a plateau before the Global Financial Crisis (GFC) struck in 2008, after which GDP fell back, recovering only in 2015. Preliminary data for the 2016 fiscal year show a sharp acceleration to 6.2% in GDP growth, which is expected to continue at 4% in the 2017 year[21].

[20] The Sheraton Hotel project was launched in the early 1990s by Italian business interests with Italian Government support, and was funded by loans that were guaranteed by the Cook Islands Government. When the project collapsed, the CIG as guarantor found itself in 1998 holding a debt of around $122 million. A negotiated write-down brought the debt to $55 million, and in 2006 this debt was extinguished by a cash payment of $14.6 million to the Italian Government (Kevin Carr pers. comm.). The remaining NZ$40 million was recorded by the Italian Government in its DAC statistics as US$24.47 million of "debt relief" ODA (http://stats.oecd.org/qwids/ search on "ODA: Italy-Cook Islands/debt relief/disbursements").

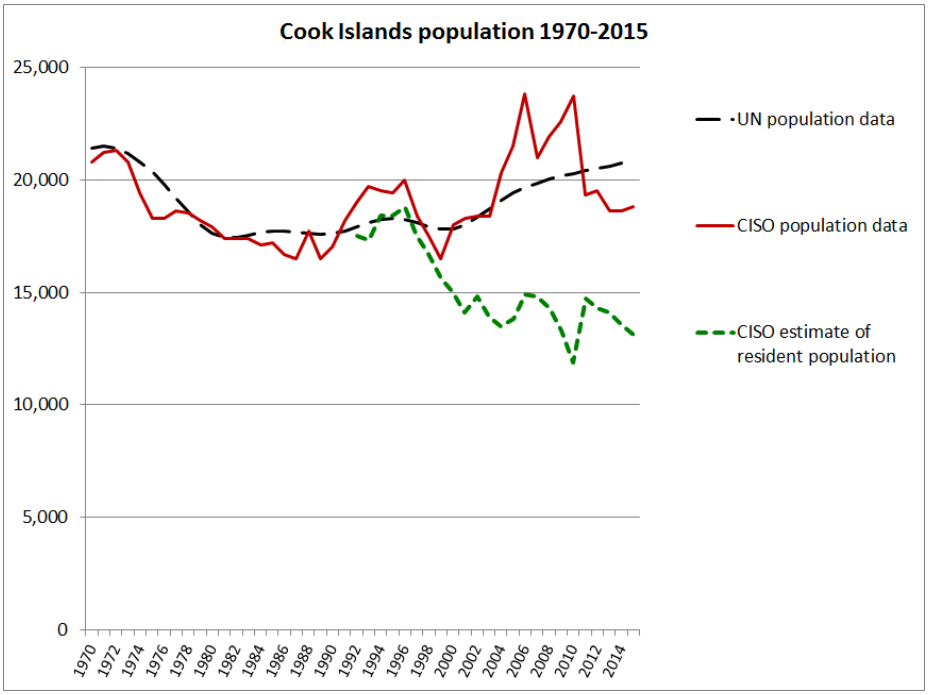
[21] Asian Development Bank *Pacific Economic Monitor* July 2016 p.5.

Figure 3.1



Sources: 1970-2011 from http://unstats.un.org/unsd/snaama/resQuery.asp accessed 17 August 2016, with the UN's 2005-base deflator rebased to 2014.
2012-2015 from CISO, *Quarterly National Accounts December quarter 2015,* http://www.mfem.gov.ck/images/documents/Statistics_Docs/1.Economic/1.National-Accounts/2015/GDP_Statistics_Tables_201504.xlsx accessed 23 September 2016.

Figure 3.2

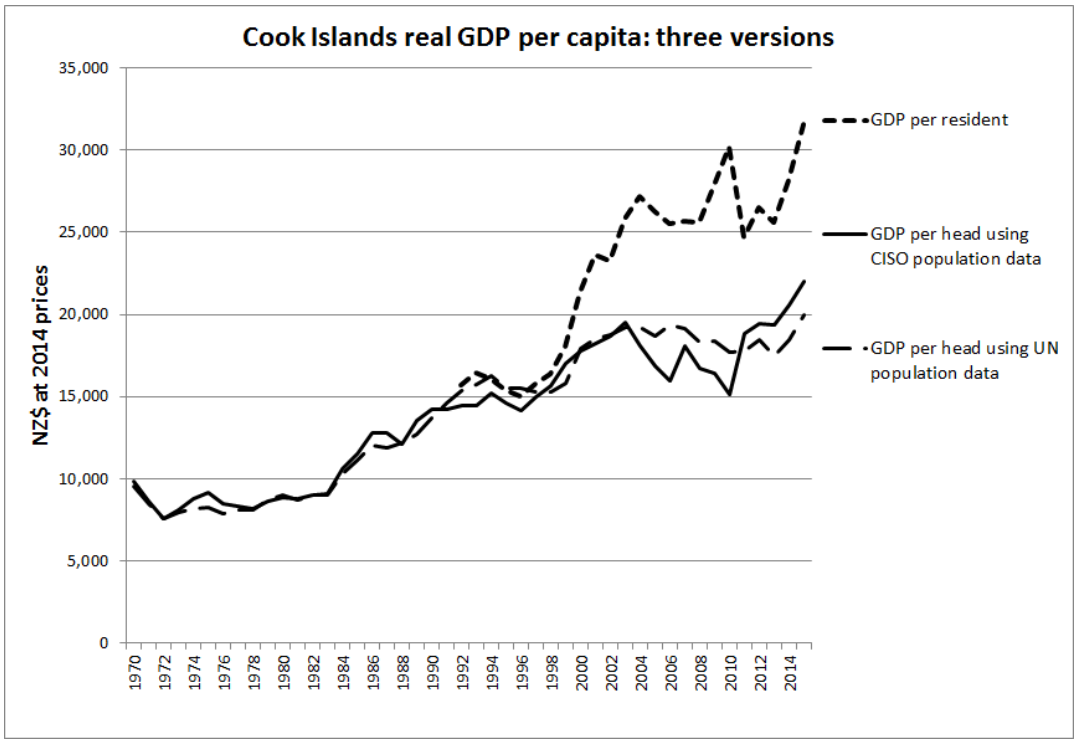


Sources: UN population from http://unstats.un.org/unsd/snaama/resQuery.asp accessed 17 August 2016.
CISO population and estimated resident population from http://www.mfem.gov.ck/images/documents/Statistics_Docs/2.Social/Population_Estimates__Vital_Statistics/2016/BDM_Statistics_Tables_201602.xls downloaded 25 September 2016, Table 1.

Figure 3.2 reveals dramatic demographic patterns. Total population, it can be seen, has fluctuated in a range between 17,000 and 23,000 over the past half-century, rising during the growth phases (when much of the growth was itself driven by the rising tourist numbers which underlie the trend of total population) and dropping when growth faltered. Resident population, meanwhile, has been on a long-run downward path from over 20,000 to less than 14,000 by 2015. The Cook Islands Maori resident population has fallen further than this, as the resident non-Maori population has increased. The short-term volatility of the resident-population series illustrates the importance of free backward and forward movement of Cook Islanders between New Zealand and the Cook Islands; this high mobility, based on shared citizenship, sets the Cook Islands labour market apart from those of other Pacific island economies that are not part of the "Realm of New Zealand".

Because per-capita income figures depend on both the numerator and denominator, it can be expected that choice of denominator will make a significant difference to the picture. Figure 3.3 presents three alternative measures of GDP per capita: first using population data from the UN (which uses the trend-smoothed population series seen in Figure 3.2), then on the basis of the CISO total population data, and finally on the basis of resident population as estimated by CISO.

Figure 3.3



Sources: Calculated using GDP from the same sources as Figure 3.1, and population series from the same sources as Figure 3.2.

Two observations follow from Figure 3.3. The first is that while the UN population series is good for reading long-term trends, use of the more detailed and volatile CISO population series picks up important short-term fluctuations – especially the appearance of a strong

upturn after the GFC. The second is that out-migration has performed the function of driving up GDP per resident to an impressive-looking level around $30,000, which would put the seal of high-income status on the Cook Islands if all the income generated in the islands were flowing through to the resident population – that is, if GNI matches GDP.

The economy of the main island, Rarotonga, exhibits (to the eye of a visiting economist) the living standards of a middle-income rather than a high-income economy; and apart from Aitutaki, the Pa Enua (outer islands) clearly have lower levels of income than Rarotonga. It was not possible during the fieldwork phase of the present project to travel beyond Rarotonga, but a virtually unanimous response from Cook Islands informants interviewed was disbelief at the proposition that the economy as a whole had achieved high-income status. Set against the statistical evidence of high and rising GDP per head (Figures 3.1-3.3 above) this raised directly the same question as the balance of payments data: whether the distribution of GDP may have been changing, with a growing share flowing out of the economy, and a falling share accruing locally.

The possible risk of developing a dual economy was explicitly recognised in 2008 by the ADB, which noted[22]

> The makeup of the country is changing as the number of foreign workers and investors rises; people of Cook Islands descent continue to depart; and fertility rates decline. The foreign, non-tourist population was estimated at 1,000 through the 1990s. Updating the estimate of the foreign, non-tourist population is largely guesswork, but it now appears to have roughly doubled to 2,000, or 10% of the total population…. Some foresee that Rarotonga and Aitutaki may evolve into high-density tourism destinations with little involvement with, or connection to, Cook Islands Maoris other than through rental payments on leased land. There is a range of potential responses to this development issue... The current approach is a middle path. Foreign workers are allowed where local skills are not available, and foreign investment is allowed under certain conditions, mostly outside of the reserved areas for local businesses.

One of the tasks undertaken during the in-country phase of this research was to seek to reconcile the qualitative impression of relatively static middle-income living standards with the statistical evidence of rapidly-rising per capita GDP over the past two decades. Given that the GDP growth has been driven almost entirely by tourism, from a development-economics perspective the question is to what extent the dynamic expansion of the tourism sector has been transmitted, via linkages and the multiplier, to the remainder of the Cook Islands economy. If tourism were to develop as a classic "enclave" export sector with only limited backward and forward linkages into the host economy, this would appear in the statistics as a growing gap between the GDP figures (reflecting the expansion of the tourism "modern sector") and other income information from the census and household surveys.

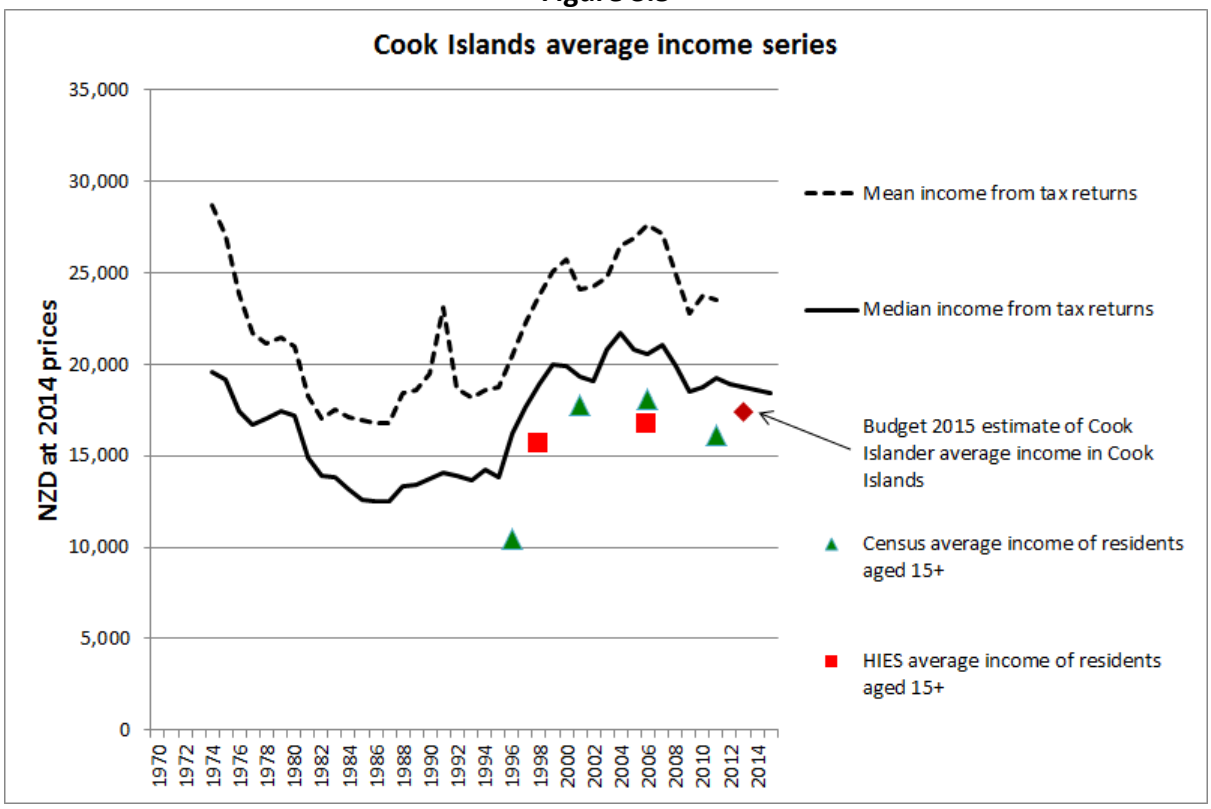
The most recent population census was conducted in 2011, and the most recent income and expenditure survey in 2006. A new household survey is currently underway, and the next census is to be taken at the end of 2016, so more up-to-date survey-based figures will not

[22] ADB 2008 p.xix-xx.

be available until next year. Data from income tax returns can, however, be used to carry the story up to 2014. The limited statistical evidence on distribution of incomes is set out in Figures 3.5 and 3.6.

Figure 3.5 shows estimates of average income derived from individual tax returns, the censuses of 2001, 2006 and 2011, the 1998 and 2006 household income and expenditure surveys, and an estimate of average incomes from a special report in the 2014/15 Budget.

Figure 3.5

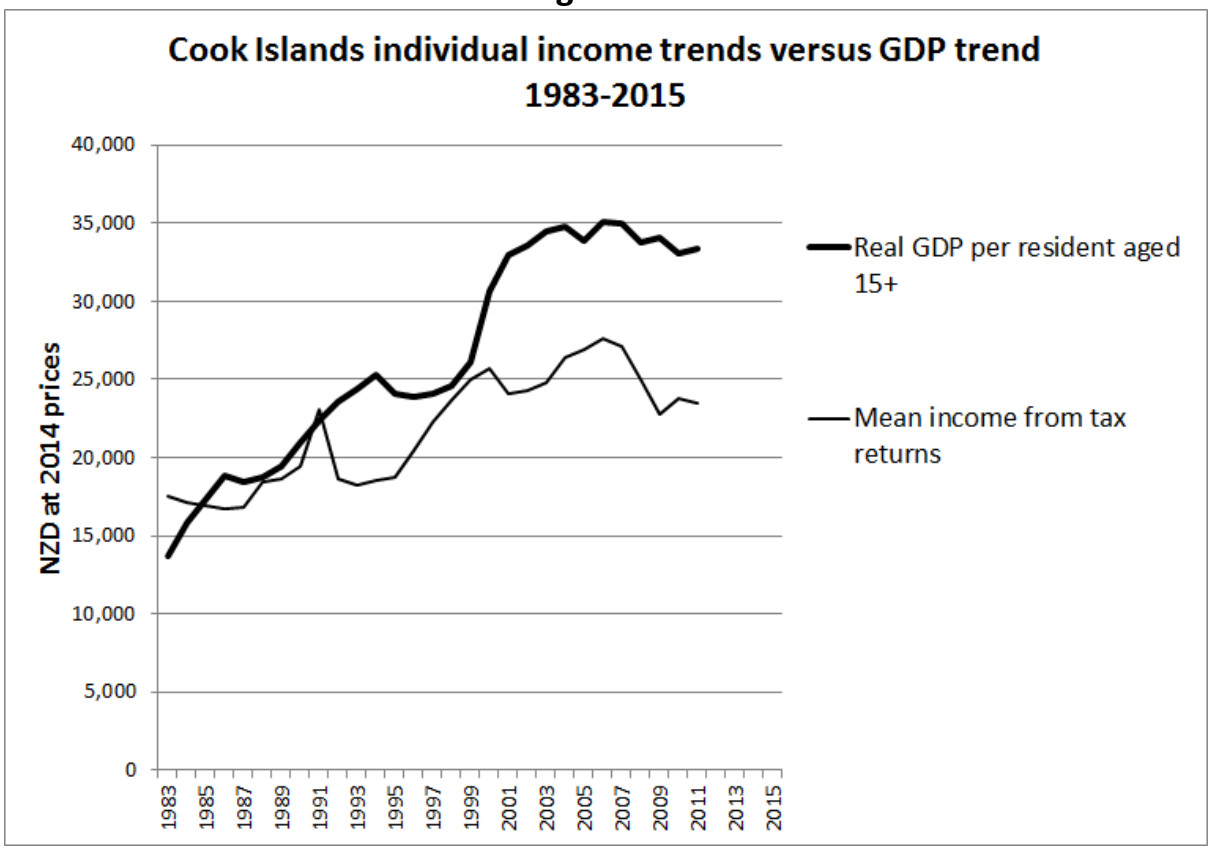


Sources: Mean and median income of individuals subject to tax returns from Table 7.3 "Income tax (IR4) Returns" in *Cook Islands Annual Statistical Bulletin*, various issues, extended beyond 2009 with figures provided by MFEM.
Census figures taken from the census reports.
HIES figures from **http://www.mfem.gov.ck/images/documents/Statistics_Docs/5.Census-Surveys/3.Income-and-Expenditure-Survey-Tables/Cook_Islands_HES_Report_2005_6.pdf** and **http://www.mfem.gov.ck/images/documents/Statistics_Docs/5.Census-Surveys/3.Income-and-Expenditure-Survey-Tables/Rarotonga_HIES_1998_Report.pdf** .
2015 Budget estimate from "Special Report: Depopulation, Income and cost of living", section 5.11 of 2014/15 Budget, Book 1, p.52.
All series deflated to 2014 dollars using the Consumer Price Index from CISO *Annual Statistical Bulletin 2010* Table 3.1, and **http://www.mfem.gov.ck/images/documents/Statistics_Docs/1.Economic/2.Consumer-Price-Index/2016/CPI_Statistics_Tables_201601.xlsx** .

All of these sources agree that in real terms, average individual incomes have been flat or falling since 2000, following a sharp increase during the depopulation of the second half of the 1990s.

The parallel tracks of mean and median income shown in Figure 3.5 indicate no worsening of the personal income distribution, at least amongst the taxpaying population. However, the flat trajectory of personal income after 2000 in Figure 3.5 is in sharp contrast to the behaviour of GDP per capita and GDP per resident, which rose steeply in the decade following 2000 before flattening after the GFC. Figure 3.6 compares GDP per resident aged 15+ with the mean income of individual taxpayers from the IR4 tax returns (the dotted line in Figure 3.5). Both these measures are simple averages with the same denominator, which makes them directly comparable. They tracked closely together from 1983 to 1999, but between 2000 and 2010 a gap of about $10,000 p.a. opened up between them, which seems likely to have persisted since.

Figure 3.6



Sources: Mean and medium income from tax returns as for Figure 3.5
Real GDP from http://unstats.un.org/unsd/snaama/selbasicFast.asp accessed 27 July 2016, divided by resident population from http://www.mfem.gov.ck/images/documents/Statistics_Docs/2.Social/Population_Estimates__Vital_Statistics/2016/BDM_Statistics_Tables_201602.xls Table 1, and resident population aged 15 and over from census reports, with intervening years interpolated.

In comparing GDP with reported monetary income, it is necessary to bear in mind that GDP includes several non-cash components that would not have been picked up in the census questionnaires: subsistence production, imputed value of home ownership, and depreciation. However, the 1998 Household Income and Expenditure Survey and the 2006 Household Expenditure Survey both included the value of "home produced goods" including

food, and also recorded actual outlays on housing including rents, mortgage payments, insurance, rates and repairs. Imputed value of home ownership in the 2015 national accounts[23] is in any case only $18.7 million compared with GDP of $421 million. These differences in coverage in the various statistical datasets do not seem likely to account for the very strong pattern in Figure 3.6.

Because (as already noted) the parallel tracks of mean and median income of taxpayers shown in Figure 3.5 indicate no worsening of the personal income distribution amongst the taxpaying population, the widening gap between mean taxable income and GDP per head seems likely to represent a shift in the functional income distribution towards an increased share of operating surplus (profits and rents), and possibly some wages, accruing to parties that did not report their income as individual Cook Islands taxpayers, during the post-2000 period of rapid tourism expansion. That points to the possible importance of offshore ownership[24] of key factors of production, and hence of net factor payments abroad.

One group that might have taken a growing share of the value-added created in tourism could be migrant workers, mainly from Fiji and the Philippines, brought in under the temporary work permit scheme to provide low-cost labour for resorts and restaurants. Work permits are granted for one year, but can be extended by two additional years. The 2011 census recorded a total of 1,219 "foreign" workers in paid employment, of which 369 were in the restaurant and accommodation sector, 196 in retail trade, and 170 in personal and community services. Of the total, workers from Fiji numbered 303, from the Philippines 158, and from other Pacific islands 90 – a total of 551 from these source countries[25]. How many foreign workers were on temporary work permits is not known, but from the above figures it seems unlikely to have been more than 500; and just over 530 temporary work contracts (presumably new issues plus extensions) were reportedly processed by the Ministry of Internal Affairs over the two years July 2012 to June 2014[26]. In the year to June 2016 558 permits were issued and 838 extended[27], indicating that around 1,300 migrant workers were under the scheme[28].

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23 http://www.mfem.gov.ck/statistics/economic-statistics/national-accounts accessed 21 September 2016.

24 Including ownership by Cook Islanders resident in New Zealand, and by those who may be resident in the Cook Islands but who operate their businesses through New Zealand bank accounts and hence receive their returns on assets overseas from the point of view of the Cook Islands national disposable income.

25 "Foreign" is defined as neither Cook Islands Maori nor part Cook Islands Maori. See Cook Islands Government 2015 pp.7-9 for discussion and Table 5 p.16 for a sectoral breakdown of "foreign" workers.

26 Ibid. p.9.

27 Information from Ministry of Internal Affairs.

28 According to ADB (2008) p.213 "permits numbering 1,618 were issued to foreign workers and investors in fiscal year (FY) 2003, and 2,114 were issued in FY2006, usually for a 12 month period. The current number seems very similar.

Most of the Cook Islands labour force in 2011 earned between $11,000 and $15,000 p.a.[29] which, even allowing for inflation since then, implies that the estimated 1,300 temporary migrant workers are extremely unlikely to be earning as much as $20 million (1,300 x 15,000) per year in total, and probably a good deal less. The official balance of payments statistics estimate outward remittances under "compensation of employees" and "personal transfers" to be running only between $2 million and $3 million per year (reportedly on the basis of Western Union data). Migrant labour, in short, cannot account for more than a small part of the "errors and omissions" row in Table 2.2.

A second, possibly important, group of recipients of tourism-generated income are absentee land owners. ADB 2008 p.82 noted that

> Cook Islanders seem to have quickly adapted to commercial signals and have increased returns from leasing land to investors. Many landowners now live offshore.

Absentee landowners are still Cook Islanders, and income flowing to them may leave the local economy but remains part of the wider Cook Islander economy. Insofar as the balance of payments "errors and omissions" flow is land rents, or operating surplus from Cook-Islander-owned tourism ventures accruing to the New Zealand bank accounts of Cook Island Maori, this is money that remains within the wider economy of the Cook Islander community which, with its crucial asset of New Zealand citizenship, operates seamlessly across the New Zealand-Cook Islands border. If proceeds from tourism development are thus raising the incomes of that wider Cook Islander community, even if not ending up in the Cook Islands local economy, the ADB's (2008) worries about foreign investment would be misplaced. From the point of view of fiscal self-sufficiency, nevertheless, the question to be addressed would be whether the Cook Islands Government could capture some of the surplus flowing to the offshore Cook Islander community – a process that would present challenges and opportunities quite distinct from those involved in taxing investment income flowing to non-Cook-Islander foreign investors.

No estimates are available of the size of annual rental payments by the tourism sector; this would be one of the major gains from development in the national accounts of a Tourism Satellite Account, which would appear to be a high-priority area for future technical assistance. At present, information about the composition and destination of outflows of funds from the tourism sector is not available. The construction and maintenance of a Tourism Satellite Account would enable policymakers to bring evidence to bear on their evaluation of the potential room to move fiscally. If $100 million p.a. of GDP is failing to "trickle down" to average incomes of the local population, it needs to be asked whether a reasonable share is "trickling across" to the public sector via taxes and other revenue-raising devices, to finance the provision of public services in the Cook Islands.

[29] Cook Islands Government 2015 p.18 Figure 11.

4. Cook Island Government finances

Government finance in the Cook Islands operates within stringent constraints imposed in the aftermath of the major fiscal crisis in the 1990s[30]. The crisis was the result of a rapid expansion of public sector employment and activity, supported partly by aid and a nascent offshore-finance operation, but mainly by large-scale overseas borrowing that proved unsustainable when the cornerstone development project – the so-called "Sheraton hotel" at Vaimaanga – collapsed[31]. Without funds sufficient to meet the costs of servicing the debt and covering its oversized payroll, the Government adopted a slash-and-burn restructuring, and accepted the restrictions demanded by its creditors on longer-run fiscal management. A radical austerity programme cut public service salaries, reduced the number of ministries from 52 to 22, cut civil service personnel by about one third from 3,200 personnel to 1,868 in 1996 (Wichman 2008 p.3; ADB 2010 p.2 paragraph 6), and passed new legislation - the Ministry of Finance and Economic Management Act 1995-96 and the Public Expenditure Review Committee and Audit Act, 1995-96 – to regulate public sector financial management.

The "principles of responsible fiscal management" set out in the MFEM Act were[32]:

- ensuring that, unless the Crown's (i.e., public sector) debt is at prudent levels, operating expenses will be less than operating revenues (i.e., there is an operating surplus);
- achieving and maintaining levels of the Crown's net worth that provide a buffer against factors that may diminish net worth in the future;
- prudently managing the fiscal risks facing the Crown; and
- pursuing policies consistent with a reasonable degree of predictability about the level and stability of tax rates in future years.

The Government's debt reportedly peaked at 140% of GDP in 1998[33], and as a condition of restructuring the debt, the 1998 "Manila Agreement" facilitated by the ADB, and signed by the governments of Italy, Nauru and New Zealand, placed numerical limits on the MFEM Act's principles of responsible management[34]. These fiscal responsibility ratios were[35]:

- tax revenue should not exceed 25% of GDP unless it is due to better compliance and efficiency,

30 IMF 2015 provides a generally favourable review of the detail of public financial management, within the narrow parameters of the PEFA.

31 Descriptions of the crisis and aftermath are in Knapman and Saldanha 1999 pp.25-48; ADB 2002; ADB 2008 p.9; ADB 2015 pp.2-3.

32 ADB 2008 p.145.

33 ADB 2008 p.17-18; data are in Figure 2.6 p.18.

34 The Manila Agreement does not have legal force, as the numerical ratios were not written into the fiscal legislation. However the ADB loans are conditional upon compliance with the ratios.

35 Asian Development Bank 2010 p.2 paragraph 5.

- public sector wages and salaries should be 44% of total revenue and are to be reduced to 40% in the out-years,
- debt servicing should not exceed 5% of total revenue,
- the overall deficit should not exceed 2% of GDP, and
- net debt should not exceed 35% of GDP.

While arbitrary, these ratios had the desired effect of imposing strict fiscal discipline, and have mostly remained operative throughout the two decades since the Manila Agreement[36]. Tax revenue is budgeted as 25.7% of GDP for the current year[37]. Public service employment (ministries, agencies, island governments and parliamentary support staff) currently stands at 1,766 (or 2,077 if SOEs are included)[38] and personnel costs are 37.3% of total revenue[39]. There is an operating surplus of 2.2% of GDP (though the overall fiscal balance, including large capital spending, is -4.1%).[40] Gross debt stands at 27.8% of GDP, and net debt servicing at 5.4%[41]. Performance against the target limits is explicitly evaluated each year in a separate chapter of the Budget.

The imposition of this fiscal straightjacket in a small developing economy with a large and growing need for public services[42] has had two collateral consequences: a long-term squeeze on public-sector salaries that has made recruitment of high-calibre staff increasingly difficult[43], and shortage of funding to support the capital spending required to improve and maintain the economy's infrastructure.

As the ADB noted in 2008 (p.xvii)

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36 ADB 2015 p. notes "The PFM system in the Cook Islands is largely a creation of the mid-1990s economic reform program (ERP). The system is based on a clear legislative framework, and the rules are well documented. It includes a set of fiscal responsibility ratios, which are used as a tool to guide public spending decisions. The ratios include a revenue boundary to limit diversion of resources away from the private sector, an expenditure boundary to control expansion in the size of the public service, and prudential boundaries to ensure that debt is managed at a sustainable level."

37 *Cook Islands Government Budget Estimates 2016/17* Book 1 p.21 Table 5.1 "Fiscal indicators summary". The 2015/16 Budget Book 1 p.18 foreshadowed reductions in the income tax rate to keep tax revenue below the ceiling.

38 Office of the Public Service Commissioner, statistics at http://www.psc.gov.ck/?page_id=3098 accessed 23 September 2016.

39 *Cook Islands Government Budget Estimates 2016/17* Book 1 p.21 Table 5.1 "Fiscal indicators summary".

40 Ibid.

41 Ibid. The 2015/16 Budget Book 1 p.22 noted that "the Government breaches the overall Budget balance in the short term due to large scale infrastructure projects which are financed by a combination of concessional lending and using cash reserves. This is expected to be a relatively short term trend due to the short term nature of the projects in question".

42 As ADB 2008 p.xiv notes, "For understandable reasons, the Cook Islands now looks to New Zealand to set its benchmarks for service standards, opportunities, and incomes".

43 The salary squeeze has been implemented partly by not indexing public sector wages and salaries to inflation, with the result that over the past decade remuneration for many staff has fallen in real terms, according to numerous informants among those interviewed. Whether the salary squeeze is attributable to the fiscal responsibility ratios, or to CIG failure to raise productivity and implement a performance framework, is contested.

> The tight fiscal management necessary to correct the Cook Islands' very high debt levels and the absence of a clear planning framework for infrastructure have contributed to a backlog of works. Roads, water, sewerage, electricity, and harbors and ports in Rarotonga and Aitutaki are potential constraints to growth over the medium term. Existing infrastructure tends to impose unnecessarily high costs on users and, in some cases, is unable to meet new demands at a reasonable cost or standard (e.g., water in Aitutaki or liquid waste disposal in Rarotonga).

The infrastructure deficit has been addressed since 2010 on the basis of a rising flow of grant aid funding from development partners including New Zealand, European Union (EU), and China, a flow which implicitly acknowledges that the ability of the Cook Islands Government itself to fund major capital works, apart from the limited remaining headroom below the 35%-of-GDP debt ceiling, is hobbled by the fiscal-responsibility restriction on raising the tax share of GDP. Aid funding for capital projects shelters the local private sector from bearing the capital cost of the infrastructure on which its prosperity depends, but by the same token means that the incentives for private sector expansion that may be provided by a low-tax environment are preserved. Raising taxes to capture more of the private-sector surplus would be straightforward in principle, but the impact of higher taxes on future development makes practical policy judgments more difficult. This is discussed further in section 6 below.

The debt ceiling of 35% of GDP - well within prudent limits - appears to enjoy strong legitimacy among CIG policymakers, the business community and the wider public. If the CIG were to access the private sector surplus by issuing local bonds, not only would the numerical ceiling be put at risk but the political legitimacy of the prudential limit on government debt would be weakened.

To show the orders of magnitude involved in the funding problem, Table 4.1 assembles the numbers and Figure 4.1, using those numbers, plots four fiscal series from 1987 (before the fiscal crisis) through to 2020 (on the basis of the latest Budget projections). The three panels of Figure 4.1 are drawn using three separate metrics: first the values in current dollars (Figure 4.1a); then in 2014 dollars using the Consumer Price Index as deflator (Figure 4.1b) and finally as percentages of GDP (Figure 4.1c).

The income side of the government accounts appears in the charts as two lines showing, respectively, current operating revenue, and total current funding comprising operating revenue plus grants of aid. The heavy black line represents the budget constraint facing the Government: all expenditure in excess of this line must be covered by running down the public sector balance sheet (that is, by borrowing or by using up cash reserves).

The expenditure side appears in Figure 4.1 as bars, with the total broken down between operating and capital spending.

Figure 4.1a

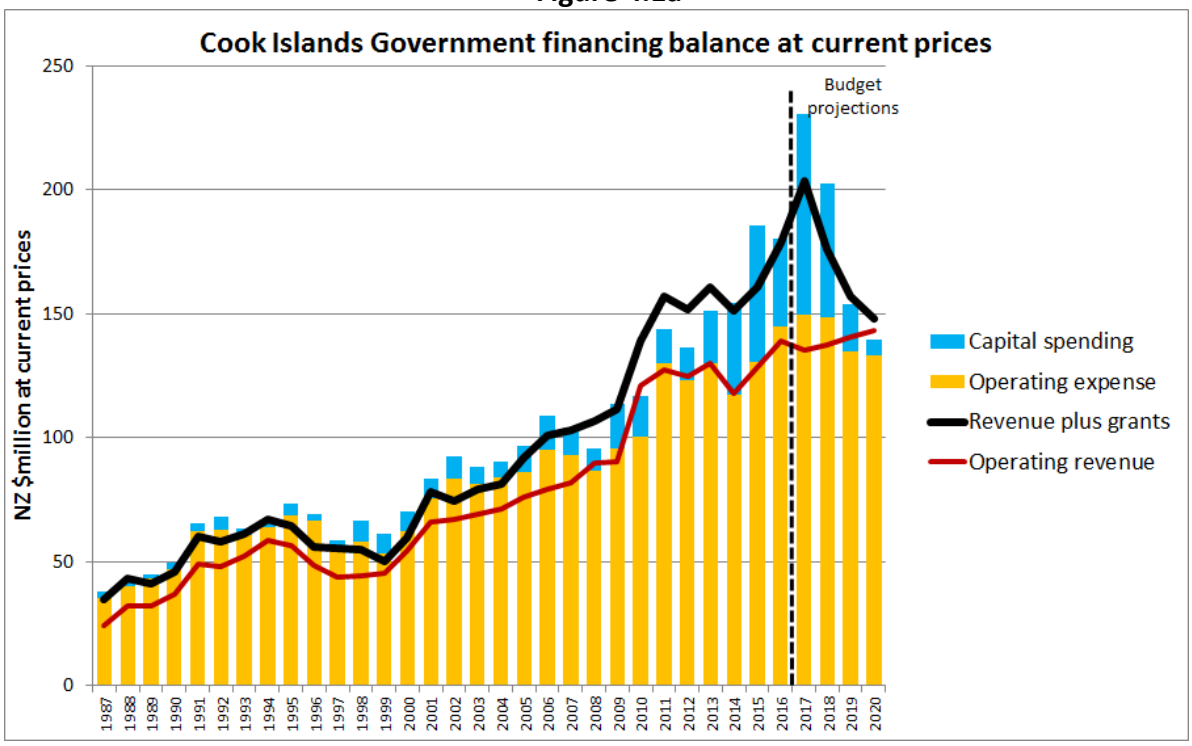


Figure 4.1b

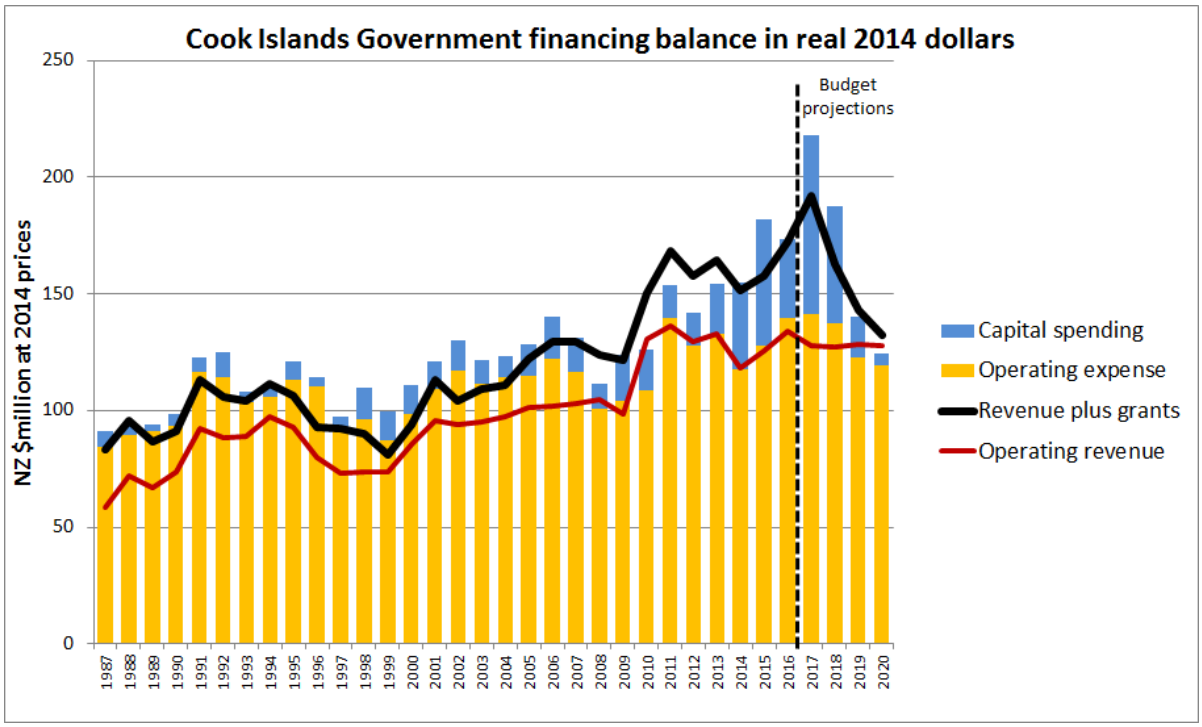
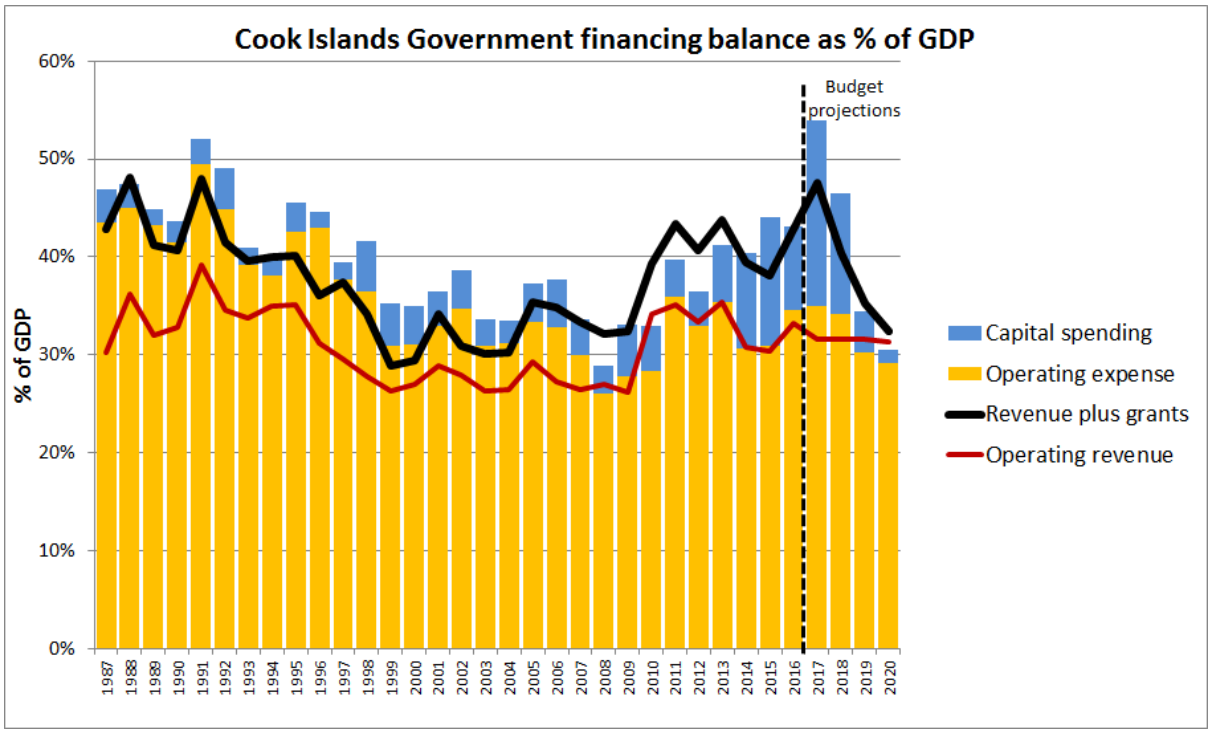


Figure 4.1c



Sources: All figures 1987-2007 from Cook Islands Statistics Office *Annual Statistical Bulletin 2010*, Table 5.1, with revenue shown exclusive of grants.

2008-2013 from Asian Development Bank database at https://sdbs.adb.org/sdbs/ downloaded 6 August 2016.

For 2014, data are from *Cook Islands Government Budget estimates 2014/15.* Revenue, expense and grants are from Book 1 pp.177-8 "Statement of fiscal responsibility", with expense adjusted to include non-capital grant-funded spending. Capital spending is from Book 3 p.3 Table 2.1, "committed".

For 2015, revenue (excluding social contributions and grants), expense (excluding social contributions), grants, and capital spending (measured as "gross transactions in non-financial assets") are from *Cook Islands Government Half-year economic and fiscal update*, p.65 Table 6.1, "GFS operating statement". (The high capital spend is confirmed by the 2015/16 Budget, Book 3 p.7, Table 2.1, "committed spend").

For years from 2016 on, *Cook Islands Government Budget estimates 2016/17* p.16 Table 4.1, "GFS statement" is used, with revenue and expense adjusted to remove grants and social contributions and with capital spending measured as "gross transactions in non-financial assets".

Deflation to 2014 dollars in Figure 4.1b is done using the Consumer Price Index from *Annual Statistical Bulletin 2010* Table 3.1, updated to 2015 using "Consumer Price Index – Tables" from http://www.mfem.gov.ck/images/documents/Statistics_Docs/1.Economic/2.Consumer-Price-Index/2016/CPI_Statistics_Tables_201601.xlsx downloaded 18 September 2016, and extended to 2020 assuming inflation at 1.9%.

GDP series to 2011 from http://unstats.un.org/unsd/snaama/resQuery.asp accessed 17 August 2016, 2012-2015 from http://www.mfem.gov.ck/images/documents/Statistics_Docs/1.Economic/1.National-Accounts/2015/GDP_Statistics_Tables_201504.xlsx accessed 23 September 2016, and 2016-2020 projections from *Budget estimates 2016/17* Book 1 p.21 Table 5.1.

Table 4.1: Cook Islands Government Finances 1987-2020, NZ$ million

	(1) Operating revenue	(2) Operating expense	(3) Operating balance (1 – 2)	(4) Grants	(5) Capital spending	(6) Overall balance (3 + 4 – 5)	(7) Revenue plus grants (1 + 4)	(8) Consumer price index 2014=100	(9) GDP
1987	24	35	-11	10	3	-3	35	42	81
1988	32	40	-8	11	2	1	43	45	90
1989	32	43	-11	9	2	-4	41	48	100
1990	37	47	-10	9	2	-3	46	50	113
1991	49	62	-13	11	3	-5	60	53	126
1992	48	63	-14	10	6	-11	58	55	140
1993	52	61	-8	9	3	-2	61	59	155
1994	59	64	-5	8	3	0	67	60	168
1995	57	69	-12	8	5	-9	65	61	161
1996	48	67	-18	8	2	-13	56	60	155
1997	44	56	-12	12	3	-3	56	60	149
1998	45	58	-14	10	8	-12	55	61	160
1999	45	54	-8	4	8	-11	50	61	173
2000	54	63	-8	5	8	-11	59	63	202
2001	66	75	-9	12	8	-5	78	69	229
2002	67	84	-17	7	9	-18	74	71	240
2003	69	81	-12	10	7	-9	79	73	263
2004	71	84	-13	10	6	-9	81	73	269
2005	76	86	-10	16	10	-5	92	75	259
2006	79	95	-16	22	14	-8	101	78	290
2007	82	93	-11	21	11	-1	103	80	310
2008	90	86	3	17	9	11	107	86	332
2009	90	95	-5	21	18	-2	111	92	344
2010	121	100	21	18	17	23	139	92	354
2011	127	130	-3	30	14	13	157	93	362
2012	125	123	2	27	13	15	152	96	373
2013	130	130	0	31	21	10	161	98	368
2014	118	118	0	33	37	-3	151	100	383
2015	128	130	-2	32	55	-25	161	102	422
2016	139	145	-6	40	36	-1	179	104	418
2017	*135*	*149*	*-14*	*68*	*81*	*-27*	*203*	*106*	*427*
2018	*137*	*148*	*-11*	*39*	*54*	*-27*	*176*	*108*	*435*
2019	*141*	*135*	*6*	*16*	*19*	*3*	*157*	*110*	*446*
2020	*143*	*133*	*10*	*5*	*6*	*9*	*148*	*112*	*457*

Sources: as for Figure 4.1. Italicised figures are projections.

The charts in Figure 4.1 are constructed with capital expenditure at the margin of the budget since this is where the funding constraint is most apparent from the donor point of view. That constraint nevertheless is felt throughout the operational parts of the public sector that deliver core social services. The 2013 expenditure review of education, for example, highlighted low teacher salaries, lack of professional development support, and insufficient funds for maintenance of school buildings. During the in-country phase of this project, interviews with educationists and observation in schools highlighted pressure on school operating budgets and difficulties of recruiting and retaining suitable staff, especially in the Pa Enua. The proportions of GDP devoted to education and health in the Cook Islands are low relative to overseas benchmarks, even after allowance is made for the fact that tertiary

levels of service can be accessed in New Zealand rather than locally. Similar financial constraints were evident in the areas covered by the Ministry of Internal Affairs (INTAFF)'s Social Impact Fund. The recently-released 2016-2020 National Sustainable Development Plan[44] sets targets for these sectors that will clearly require increases in their budgetary appropriations.

The unsustainability of the fiscal position of the late 1980s heading into the early 1990s is clearly apparent in Figure 4.1, with expenditure running 10% of GDP ahead of revenue even with very low capital spending. There was continued, but falling, reliance on borrowing and other funding options in the post-crisis decade as restructuring proceeded, bringing the government into the black by fiscal 2007. The renewed availability of grant aid beginning about 2010 opened the way for the major capital works currently underway. The lag in implementation of the projects is clearly visible as periods when expenditure is inside or outside the budget constraint, as funds were accumulated in some years and carried forward to be spent later. As can be seen, the current Budget anticipates such deferred capital spending being implemented in fiscal 2017 and 2018 before tailing off dramatically as existing aid commitments are used up. However, it is expected that new tranches of grant aid will be forthcoming for projects that are currently in the planning stage, such as the broadband fibre and sewage reticulation projects.

The economy's apparently high private-sector savings rate would in theory suffice to fund these infrastructural needs, if that surplus were available to Government; but the fiscal responsibility limits leave the public sector reliant on external donors to fund its capital spending. The Government is barred by its fiscal limits from either taxing or borrowing to capture the private-sector surplus, and because the economy uses the New Zealand dollar, the Government is equally barred from using money creation to finance projects. Meanwhile the private sector's savings are not invested locally but instead flow offshore, potentially funding private investments in the donor countries. Obvious remedies would be for the Government to increase tax rates, or issue bonds, to secure funding for its capital works programme; but these measures would violate respectively the 25% of GDP tax ceiling and the 35% of GDP debt ceiling, and so are ruled out as policy options so long as the fiscal ceilings remain in place.

In short a central role now performed by aid in the Cook Islands is to enable essential public works to be carried out while keeping the government sector small enough to avoid "crowding out" the private sector[45]. No research has been located during the current project that addresses directly the question of whether the perceived (and frequently referred to) crowding-out tradeoff is genuinely a binding constraint on the economy's pursuit of fiscal "self-sufficiency". Insofar as the fiscal ratios laid down by the Manila

[44] Cook Islands Government 2016.

[45] ADB 2015 pp.6 and 10 offers the clear recommendation to "halt further public sector size increases", in the context of a report devoted to stimulating private sector investment which sees a clear need to "limit diversion of resources away from the private sector".

Agreement are unduly restrictive, and insofar as "increased self-sufficiency" is in fact a meaningful development-policy goal, this would clearly need to be explored further. While that empirical task lies beyond the scope of the current project, the crowding-out issue is central to the identification of "key revenue risks and opportunities" and so is reviewed in the next section.

A final issue that constrains fiscal policy-making in the Cook Islands is the time-limited blocks in which both New Zealand and EU budget support is provided - triennial blocks in the case of New Zealand. Although this tier of aid now accounts for less than 10% of operating revenue, the CIG in its forward budget planning currently makes the assumption that budget support will terminate in 2018 when the current triennium terminates, because beyond that date there is no explicit assurance of ongoing support, whatever expectations may reasonably be held regarding ongoing New Zealand assistance. It would clearly be of great assistance to CIG budgetary forecasting to have budget support provided on a more assured basis such as a rolling three-year or five-year programme.

Faced with the combination of no guarantee, but the strong probability, of budget-support funding eventuating, one rational response for the Cook Islands Government would be to self-insure, in the form of a buffer fund to enable budget planning to be done over a longer horizon than the present one of less than two years. Such a fund's function would be to manage short-term threatened revenue fluctuations - including volatile fishing and tourism-derived revenues, and other donors' aid flows as well as uncertain budget support - rather than the longer-term intertemporal redistribution that is the usual basis for sovereign wealth funds in other jurisdictions[46]. It would need to be funded initially from any short-term revenue windfalls that may accrue, and once established would provide continued insurance against any fiscally-imposed sudden stop. The difficulty of establishing such a fund with entrenched immunity from being raided for opportunistic politically-driven spending should not be under-estimated, but experience with the National Superannuation Fund provides a useful precedent.

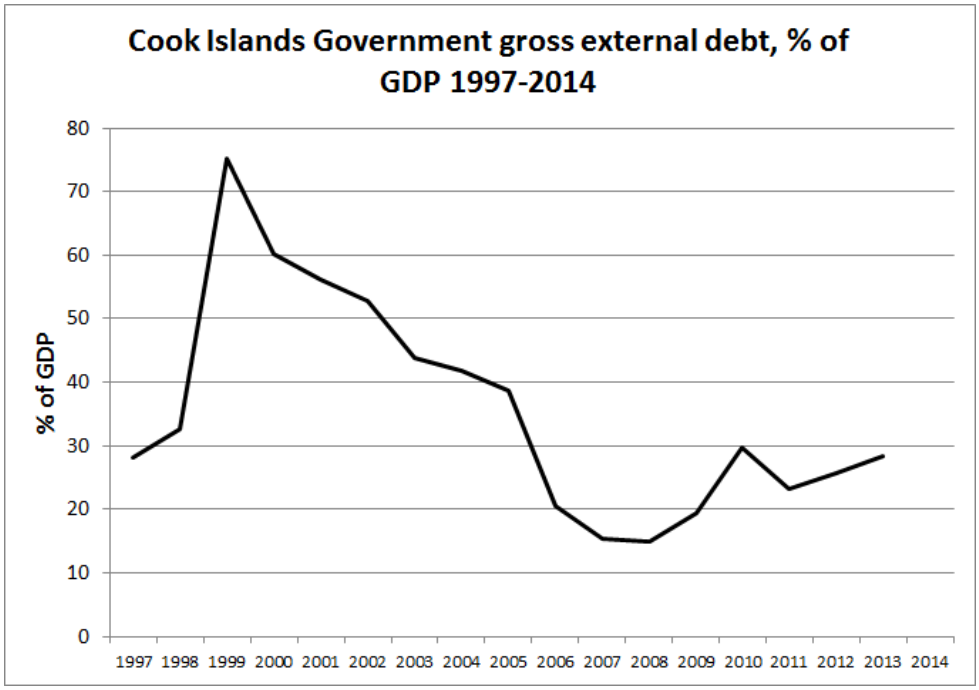
Figure 4.2 traces the evolution of the CIG's external debt since 1997, and Table 4.2 shows the New Zealand dollar value of the gross and net external debt at the end of the past four fiscal years, broken down by creditor. The ADB and China are the dominant lenders, with China raising its share rapidly in recent years. Because most of the debt is denominated in SDRs and renminbi, it is exposed to exchange rate risk on the New Zealand dollar, but the level of debt is sufficiently low to make this of very limited concern, and the sinking-fund arrangement known as the Loan Repayment Reserve Fund provides an additional buffer.

Following elimination of the overhang of "Sheraton" debt in 2006, new loans from the ADB to fund port development and economic recovery took the gross debt up to 25-30% of GDP, where it has remained since. Net debt (gross debt minus the Loan Repayment Fund) is

[46] There is currently a proposal to set up a Cook Islands Sovereign Wealth Fund to handle anticipated revenues from seabed mining; a short-term buffer fund would presumably be separate from this.

currently at around 22%, leaving scope for up to $25 million of new borrowing to be incurred without taking it over the fiscal responsibility limit of 30% (that is, the Manila Agreement's 35% minus a 5% buffer that the CIG itself imposes to provide security against natural disasters). The 2016/17 Budget[47] foreshadows utilisation of this $25 million permissible new borrowing to fund the Pacific Connectivity Project and the Muri Sewage Reticulation project, which would leave net debt hard against the ceiling.

Figure 4.2



Source: ADB *Key Indicators for Asia and the Pacific 2015*: Cook Islands, https://www.adb.org/sites/default/files/publication/175162/coo.pdf .

Table 4.2
Gross external debt and Loan Repayment Reserve balance

	2013	2014	2015	2016
Creditor:				
ADB	71.54	65.95	64.72	79.06
China	14.25	19.26	23.91	39.35
France	3.20	2.56	1.84	1.84
ANZ Bank		3.09		
Total gross debt $m	**88.98**	**90.85**	**90.46**	**120.20**
% of GDP	*24%*	*24%*	*21%*	*27%*
Loan Repayment Reserve Fund	17.88	16.87	16.64	17.26
Net debt $m	**71.10**	**73.99**	**73.82**	**94.70**
% of GDP	*19%*	*19%*	*18%*	*22%*

Sources: 2012/13 Budget Book 1 p.100 Table 10.2; *June 2014 Quarterly Financial Report* p.14 Table 13; *2015/16 Half Yearly Economic and Fiscal Update* December 2015 p.73 Table 7.3; 2016/17 Budget Book 1 p.117 Table 10.1.

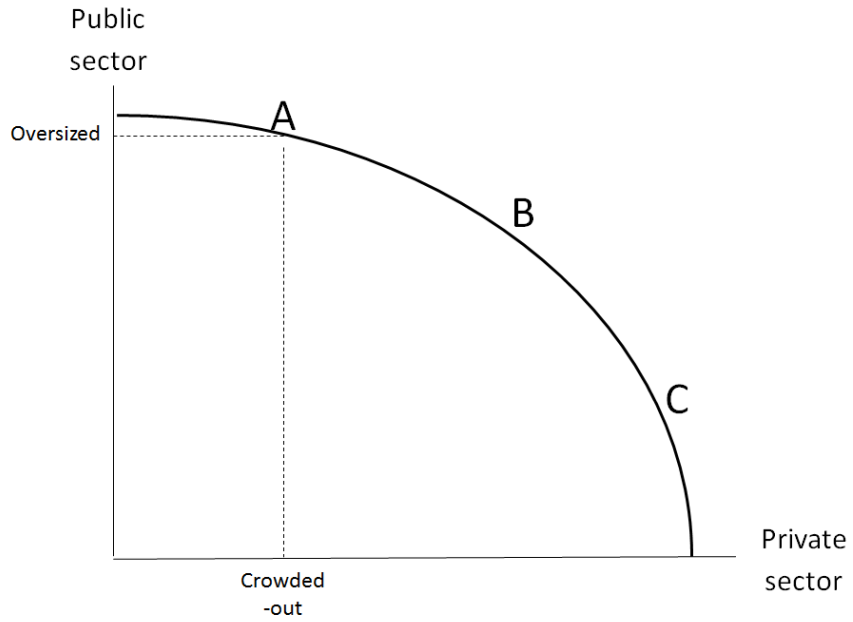
[47] 2016/17 Budget Book 1 p.127.

5. A digression on crowding-out

The need to draw on external aid funding to meet infrastructural investment needs arises not from any lack of domestic savings, but from the desire of key donors and of the CIG to maintain and enhance the quality of public services without requiring an expansion of the public sector's revenue base that might crowd-out private sector activity.

The familiar theoretical model of "crowding-out" is drawn from the textbook model of an economy with a fixed domestic resource endowment. When that model is applied without necessary modifications to a radically open economy – one that is not simply open to trade, but also has open capital and labour markets - in the context of a fixed exchange rate, exogenously-determined monetary policy with a common currency, and citizenship shared with a large neighbouring economy, it is important to take full account of the processes whereby domestic policies intended to produce inter-sectoral reallocation of resources within the domestic economy will have collateral effects due to inter-national reallocations of the footloose factors of production, capital and labour.

The textbook crowding-out model is summarised in the "production frontier" diagram, usually drawn as an outward-bowed curve to incorporate the notion of diminishing returns. In the simplest version, assume the economy is at full employment with no trade, capital flows or labour migration, with its own currency, and with two sectors, public and private. Then at any given level of national product, expansion of one sector can occur only at the expense of the other.



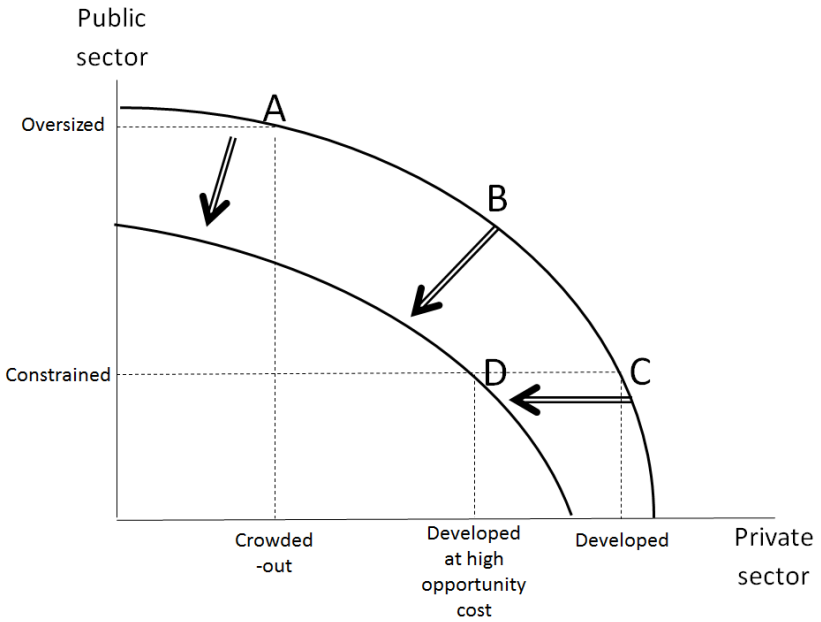
The three points A, B and C are all feasible with the given stock of resources, but they represent different structures of output. At A the economy is dominated by the public sector, with the private sector reduced (crowded-out) to a minor role. At C the economy is dominated by the private sector with a much smaller public sector. B has the two sectors roughly equal. If one starts at A, then with the given resource endowment and production

frontier the private sector can be expanded only by shrinking the public sector because, given the economy's fixed supply of resources, some of those resources must be reallocated out of the public sector if the private sector is to expand. By placing rigorous limits on the size of government, the closed economy can in theory be moved around to C with labour and capital leaving the public sector and finding employment in the private sector.

Opening the economy to trade in goods and services leaves the basic analysis intact. With land, labour and capital all locked into the home economy, production still takes place on the given frontier, which (to repeat) is fixed in place by the fixed resource endowment. Specialisation and trade according to comparative advantage improves welfare but does not change the basic production model.

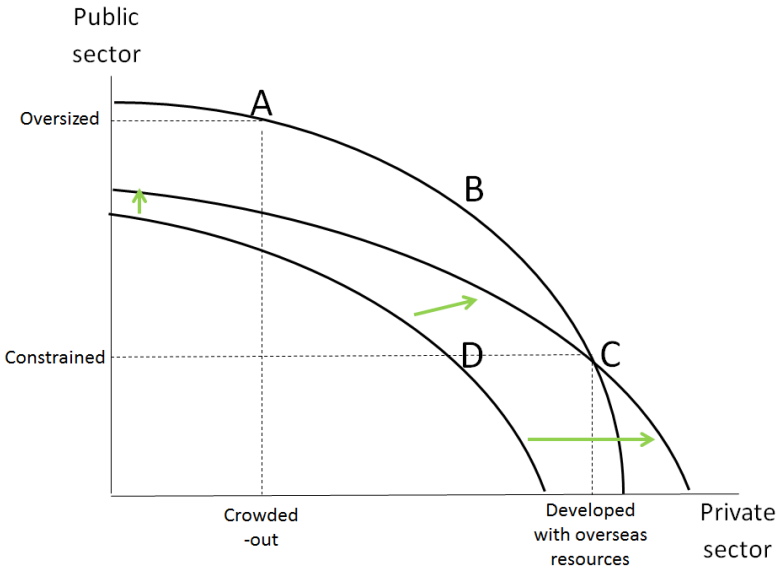
In 1996, development of the Cook Islands economy was thought to hinge on expansion of the private sector, especially the tourism industry. To clear the way for this, it was argued that resources had to be squeezed out of the public sector to make them available to the private sector. Hence while the radical austerity policies prescribed in 1996 and 1998 were primarily required to address the fiscal crisis, they were designed and promoted partly on the basis of the crowding-out model[48].

The outcome showed how the simple production-frontier model requires modification when both labour and capital markets are open. The footloose resources squeezed out of the public sector did not all reallocate to the private sector; on the contrary, many of them moved offshore, effectively pulling the production function inwards. The remainder did reallocate to the private sector, which duly expanded – but only to point D, not to point C on the original frontier.



[48] Wichman 2008.

Subsequently resources from offshore – overseas savings, and migrant contract workers - flowed into the private sector, enabling it to grow by pushing the production frontier back out again. This was not, however, a development process based on full utilisation of the home resources that were available at the outset. It involved the replacement of some local capital and labour with some in-migrant labour and offshore capital.



At the end of the process the desired move from A to C was accomplished, but this outcome was achieved only partially by transformation of the pre-existing economy. A large part of the story was the replacement of one set of labour and capital resources by another, leading to an economic structure which exhibits large outward remittances of income while the public sector remains tightly constrained. Along the new production frontier, the public sector can be expanded again using local resources only at much higher opportunity cost than originally, because of the reduced resident stock of local labour (and possibly also of fixed capital).

The only resource that is not footloose is land – the natural resource endowment – which remains in place, and which because of the "customary" land tenure regime remains in Cook Islands ownership, albeit leased to an unknown extent to non-Cook Islanders.

The gradual degradation of the natural environment resulting from the public-sector constraint is now being addressed by the injection of further offshore resources in the form of aid grants to fund large-scale projects in water supply, electricity, sanitation and waste disposal – effectively pushing the production frontier back up towards its original shape and enabling the public sector to expand its service, but without putting pressure on the local private sector.

From the point of view of increasing fiscal self-sufficiency, the essential question is whether there exists a feasible path that would enable the public sector to grow with less reliance on aid donors, by capturing a larger part of the flow of private sector savings that are now

flowing out of the economy, and investing these funds in local infrastructure – effectively a process of pushing the production frontier up on the basis of reinvested locally-produced surplus rather than externally-provided aid. Doing this by a squeeze on the private sector similar to the 1996 austerity squeeze on government would present the risk of repeating the process whereby resources simply migrate offshore, leaving the tourism sector decapitalised and the economy as a whole less well-endowed. However, it is an open question whether some part of the outward flow of funds could not be diverted to infrastructure investment without killing off the tourism sector. There would seem to be a range of policy options to be explored here, all of which undeniably and unavoidably involve encroaching on the short-term after-tax profitability of the private sector (whether by direct taxation to secure investment funds, or by increased charges to recover the cost of infrastructure investments in the event of these being funded by government borrowing or through public-private partnerships).

The economic literature contains a good deal of discussion of "sudden stops" in developing economies. The 1996 austerity programme in the Cook Islands was potentially such a sudden-stop experiment, but the rapid expansion of tourism from 2000 quickly outweighed the macroeconomic impact of the stop. The ADB has interpreted this externally-driven expansion as a "growth dividend" from the austerity programme, but in fact it may have been largely fortuitous - a windfall gain from capital and labour inflow that was motivated less by the fiscal straightjacket on government than by the opportunities opened up by the Fiji coups and the Bali bombing, both of which diverted tourist traffic to safer, more politically-stable destinations. It may be that the 25%-of-GDP limit on taxes helped to make the Cook Islands an attractive investment for private capital, but it can be argued that this was a secondary factor, not the primary factor, driving the tourism expansion. What is now beyond doubt is that unless some means can be found to capture the private-sector surplus for public purposes, the improvement and maintenance of infrastructure can be achieved only by externally-sourced capital grants of aid.

The priority assigned by MFAT to further expansion of the private tourist sector has to date translated directly into New Zealand's provision of financial support for infrastructure:[49]

> MFAT's new JCfD establishes 'enhanced economic self-sufficiency' as the overarching objective for the Cook Islands Programme and clearly identifies sustainable growth in the tourism industry as the best mechanism for achieving this. The JCfD continues support to the Cook Islands tourism sector, and increases support for the development of a whole-of-government strategy for promoting (re)-investment in the sector.
>
> New Zealand's on-going infrastructure support is focused on infrastructure critical to a sustainable tourism industry: clean and reliable energy, drinking water and sanitation.

This approach, of having Wellington finance infrastructure investment rather than levying taxes on locally-generated economic surplus to provide investment resources, is clearly one

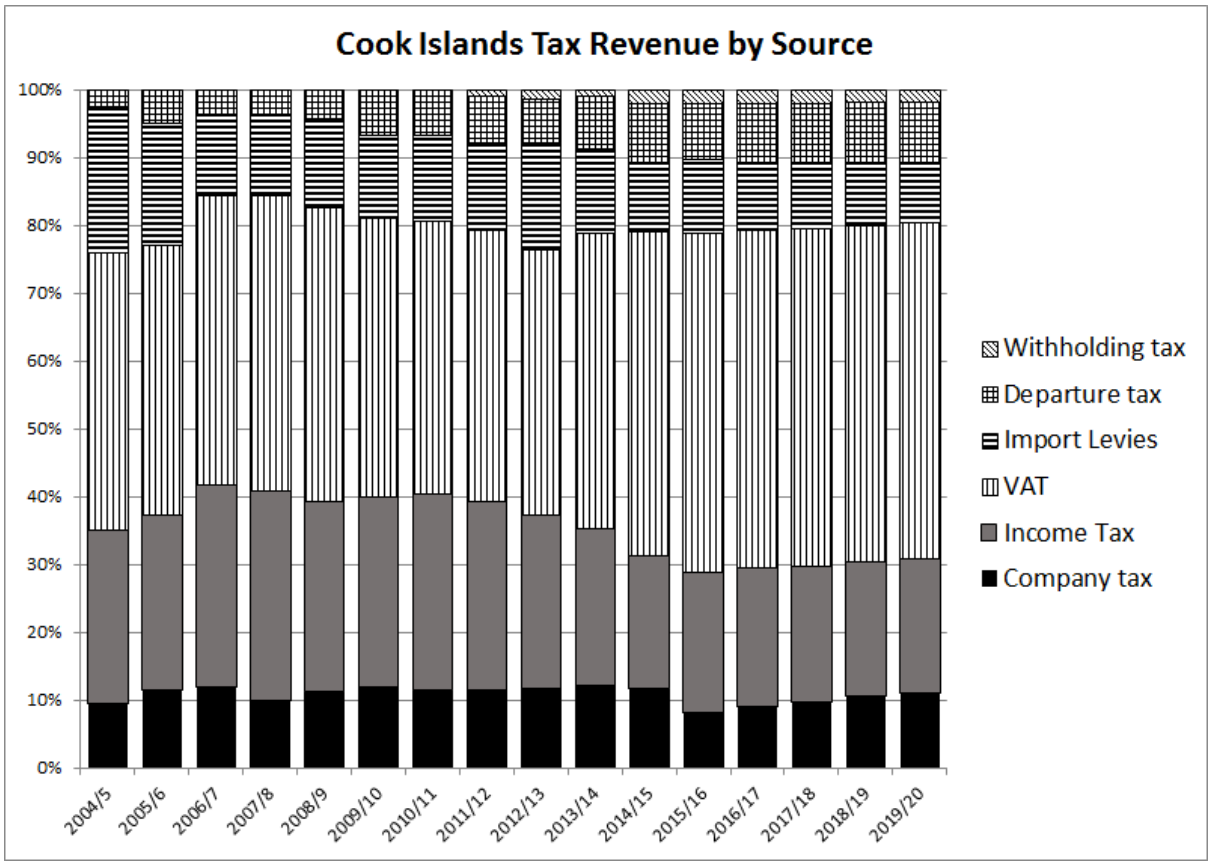
[49] "MFAT management response to recommendations from the 2015 evaluation of the Cook Islands Country Programme" at https://www.mfat.govt.nz/assets/_securedfiles/Aid-Prog-docs/Evaluations/June-2016/Cook-Islands-Evaluation-Management-Response-2015.pdf .

way of avoiding any possible emergence of crowding-out, and is consistent with funding arrangements commonly encountered within mainland New Zealand – for example in relation to Auckland and Wellington transport infrastructure, and the Christchurch post-earthquake rebuild.

6. The Cook Islands tax system

The Cook Islands tax system is made up of four major categories of taxes: direct taxes on income and profits, VAT, airport departure tax, and import duties. Figure 6.1 shows their relative importance.

Figure 6.1



Source: Data supplied by MFEM.

Direct taxes – 30% of the total - are made up of individual income tax and company tax. The company tax rate is a flat 20% for resident companies and 28% for non-resident companies. The income tax scale has a rate of 17.5% on income $11,000-30,000, 27.5% on income above $30,000, and 30% on income above $80,000. The 2015/16 Budget (Book 1 p.18) declared that

> The Government intends to further lower the income tax rate from 18.5 per cent in 2015, to 17.5 per cent from 1 January 2016, and 17 per cent from 1 January 2017."

In contrast the New Zealand company tax rate is 28% and the income tax rate is 30% on incomes $48,000-70,000 and then a top rate of 33% on incomes over $70,000, which means that Cook Islands rates are significantly lower for high-income individuals and dramatically lower for companies resident in the Cook Islands.

Compared with New Zealand and Australia, these figures indicate that the Cook Islands is a low-tax economy, especially with regard to direct income taxes. Table 6.1 compares the Cook Islands with New Zealand with all values expressed as % of GDP.

Table 6.2 assembles figures on the revenue collected by the Cook Islands Government from the various tax categories over the period 2009-2016, along with the current Budget projections through to 2020. The top panel of the table shows the dollar figures; the lower panel shows these as percentages of Cook Islands GDP. Total tax revenues from all sources are roughly one-quarter of GDP, with direct taxes running generally below 10% of GDP.

Table 6.1: Tax revenues as % of GDP – Cook Islands and New Zealand compared

	2009	2010	2011	2012	2013	2014	2015
Taxes on income, profit and capital gains payable by individuals							
Cook Islands	7.4%	7.1%	7.3%	7.0%	6.9%	6.0%	5.1%
New Zealand	15.4%	13.5%	12.5%	12.4%	12.9%	13.0%	13.4%
Taxes on income, profit and capital gains payable by corporations and other enterprises							
Cook Islands	1.6%	2.8%	2.5%	1.4%	3.2%	3.1%	3.0%
New Zealand	6.1%	4.3%	4.3%	5.1%	5.3%	5.3%	5.6%
Taxes on goods and services							
Cook Islands	9.1%	9.9%	9.8%	8.5%	10.1%	9.1%	8.2%
New Zealand	8.9%	9.0%	9.8%	10.1%	10.1%	10.2%	10.3%
Taxes on international trade and transactions							
Cook Islands	2.8%	2.8%	3.0%	3.0%	4.2%	3.2%	2.7%
New Zealand	1.1%	1.0%	1.0%	1.0%	1.0%	1.0%	1.1%
Other taxes							
Cook Islands	1.2%	1.7%	1.8%	1.8%	2.1%	2.3%	2.8%
New Zealand	1.5%	1.5%	1.6%	1.6%	1.7%	1.7%	1.6%
Total taxes							
Cook Islands	22.7%	24.9%	25.0%	22.5%	26.9%	25.9%	26.1%
New Zealand	31.5%	27.9%	27.6%	28.6%	29.3%	29.4%	30.4%

Sources: Cook Islands as for Table 4.1. New Zealand tax revenue from http://www.stats.govt.nz/~/media/Statistics/Browse%20for%20stats/GovernmentFinanceStatisticsCentralGovernment/HOTPYeJun15/gfscg-yejun15-tables.xls downloaded 22 September 2016, and GDP from http://unstats.un.org/unsd/snaama/selbasicFast.asp accessed 22 September 2016.

Table 6.2: Cook Islands Government tax revenue 2009-2020

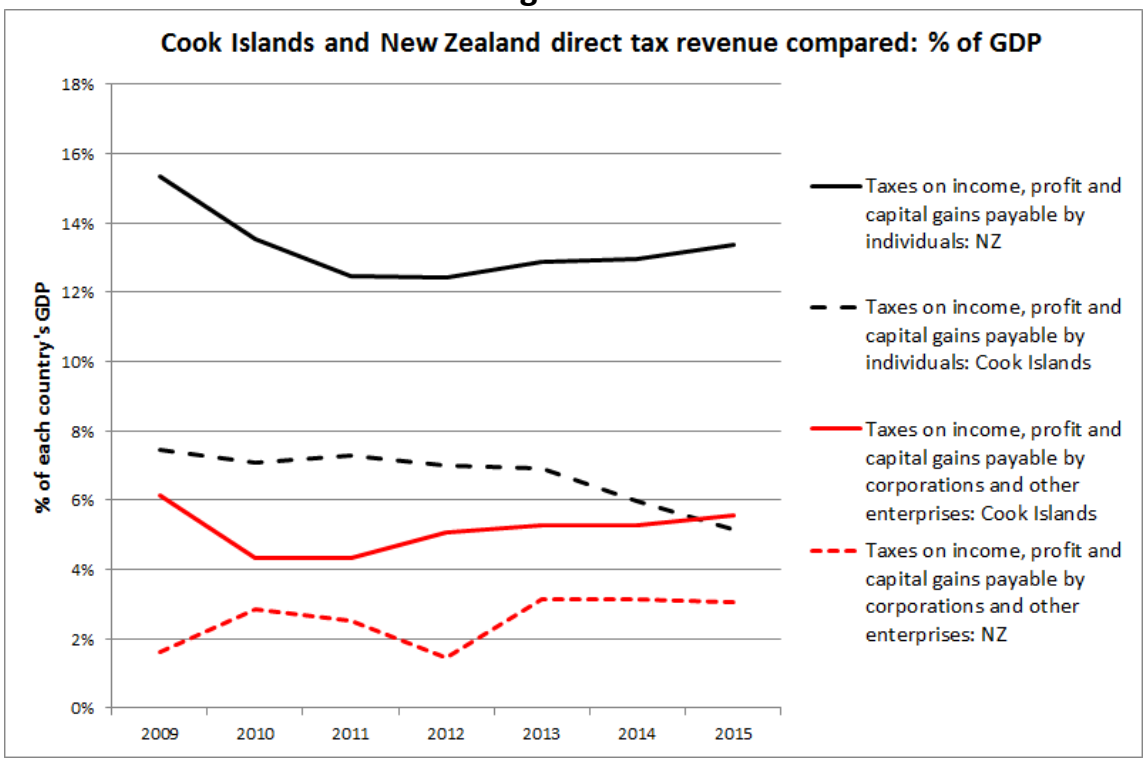
	Actual								Budget projections			
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Individual income tax	25,604	25,128	26,361	26,632	24,934	22,442	19,836	23,009	22,942	22,981	23,259	23,583
Company tax	5,610	10,077	9,181	5,482	11,342	11,781	11,740	9,071	10,091	10,941	12,371	13,191
Total direct tax	31,214	35,205	35,542	32,114	36,276	34,223	31,576	32,080	33,033	33,922	35,630	36,774
VAT	33,060	36,879	37,381	34,975	38,074	42,365	48,078	56,081	55,582	56,631	58,132	59,599
Taxes on international trade	9,745	10,033	11,052	11,391	15,053	11,999	10,409	12,058	11,366	11,084	10,801	10,516
Other taxes	4,161	6,146	6,543	6,847	7,602	8,587	10,784	11,598	9,653	10,026	10,370	10,703
Total tax revenue	**78,180**	**88,263**	**90,518**	**85,327**	**97,005**	**97,174**	**100,847**	**111,817**	**109,634**	**111,663**	**114,933**	**117,592**
GDP	343,700	354,100	362,400	379,400	360,000	374,807	*386,100*[1]	*397,600*[1]				
Taxes as % of GDP												
Individual income tax	7%	7%	7%	7%	7%	6%	5%	*6%*				
Company tax	2%	3%	3%	1%	3%	3%	3%	*2%*				
Total direct tax	9%	10%	10%	8%	10%	9%	8%	*8%*				
VAT	10%	10%	10%	9%	11%	11%	12%	*14%*				
Taxes on international trade	3%	3%	3%	3%	4%	A 3%	3%	*3%*				
Other taxes	1%	2%	2%	2%	2%	2%	3%	*3%*				
Total tax revenue	**23%**	**25%**	**25%**	**22%**	**27%**	**26%**	**26%**	***28%***				

1. GDP 2015 and 2016 estimated assuming a 3% annual growth rate.

Sources: 2009-12 from *Cook Islands Government Finance Statistics 2009-2013* http://www.mfem.gov.ck/images/documents/Statistics_Docs/1.Economic/4.Government-Finance-Statistics/Cook_Island_Government_Finance_Statistics_2009-2013.pdf downloaded August 2016.
2013-14 from *Quarterly Financial Report June 2014* http://www.mfem.gov.ck/treasury/e-library?view=download&format=raw&fileId=2318 downloaded 21 September 2016, p.5 Table 4 "General Government revenue summary".
2015 from *2015/16 Half-yearly Economic and Fiscal Update* dated December 2015, p.97, table headed "Revenue levied on behalf of the Crown".
2016-20 from *Budget Estimates 2016/17* Book 1 p.77 Table 7.8.
GDP to 2014 from http://unstats.un.org/unsd/snaama/selbasicFast.asp accessed 27 July 2016.

The Cook Islands is roughly equal to New Zealand in the proportional burden of VAT/GST, has higher import tariffs, but has dramatically lower direct taxes on individuals and businesses, adding up to roughly a 4%-of-GDP lower tax burden. Given the close integration between the New Zealand and Cook Islands economies in terms of capital and labour mobility, it would be expected that tax planning would encourage investors to locate business enterprises in the Cook Islands for tax purposes, but to accumulate after-tax profits in New Zealand, and this may well be the explanation for the reported large balance-of-payments surplus discussed on pages 6-11 above. Figure 6.2 charts the contrast between the two jurisdictions in terms of the burden of direct taxes.

Figure 6.2



Source: Table 6.2.

These figures seem to indicate that there is probably untapped revenue-raising potential in the Cook Islands economy, which has not been accessed because of the 25%-of-GDP limit on tax revenue imposed by the 1998 Manila Agreement. There may now be an opportunity to reconsider this limit, especially with regard to the company tax rate. Raising the company tax rate to or towards 28% to match that in New Zealand should be straightforward and need not cause any withdrawal of already-committed capital, but the effects on future investment and reinvestment would need to be evaluated.

The economy's leading sector, tourism, ought to be able to bear an increased tax burden to fund some of the government expenditures that currently absorb the budget support grants from New Zealand and the EU. The tourism sector is the prime

beneficiary both of the infrastructure investment undertaken by the Government and of the Air New Zealand underwrite/subsidy[50]. There may well be a case for introducing a new tax targeted directly at the tourism sector – either a bed tax (or turnover tax, similar to that in Fiji) or a toilet tax (the latter possibly calibrated to reward high-quality sanitation installations).

Table 6.3: The Air New Zealand Underwrite

	Air NZ underwrite: spending, NZ $million	% of CIG operating expense	% of CIG operating revenue
2008	3,036	3%	4%
2009	2,982	3%	3%
2010	1,912	2%	2%
2011	4,486	4%	3%
2012	11,829	10%	10%
2013	9,454	7%	7%
2014	11,102	9%	9%
2015	10,500	8%	8%
2016	6,050	4%	4%
2017	9,500	7%	6%
2018	12,000	9%	8%
2019	12,000	9%	9%
2020	12,000	8%	9%

Sources: *Annual Reports of the Government of the Cook Islands* for 2009, 2011 and 2012; June 2014 *Quarterly Financial Statement* p.8 Table 6; 2016/17 Budget Book 1 p.105 Table 8.15.

The perceived need for the Cook Islands Government to fund an annual subsidy to Air New Zealand in order to secure airline connections to Los Angeles and Sydney involves a very substantial *de facto* subsidy to tourism operators, the cost of which could well be targeted onto the sector. Although initially part-funded out of New Zealand sector support to tourism, the underwrite is now simply included amongst the general set of "payments on behalf of Crown" (POBOCs) in the annual budget. There could be a strong case for transferring responsibility for the subsidy to the Tourism Corporation or the Tourism Council, and leaving it up to the industry itself to determine whether the subsidy is providing value for money, and if so how the money is best raised from the beneficiaries[51]. Table 6.3 sets out the sums expended out of general revenue to

[50] ADB 2008 p.86 argued strongly against this subsidy: "Paying financial incentives to induce Air New Zealand to resume direct Los Angeles–Rarotonga–Auckland flights to offset its losses on the route should not be contemplated. Such subsidies are unlikely effective and could end up being very costly per additional tourist arrival."

[51] An economic evaluation of the Air New Zealand underwrite was conducted in 2016 by Masters Economics (see Fairgray 2016). However, the modelling approach taken rested entirely on an untested assumption: that without the underwrite, the Air New Zealand services to Los Angeles and Sydney would cease and not be replaced in whole or in part by other carriers. Insofar as this extreme "bang-bang" assumption does not in fact hold, the remainder of the multiplier analysis conducted by the consultants would not serve as a measure of net economic benefits from the subsidy. The study, in other words, analysed not the economic effects of the subsidy, but simply

subsidise Air New Zealand since 2008, along with the current budget projection to 2020.

There are thus a number of initiatives that could significantly strengthen the Cook Islands Government's fiscal position, either by increasing or introducing some taxes, or by shifting a major item of recurrent expenditure into the private sector, or both.

In the light of optimistic current growth projections, the tax revenue projection in the 2016/17 Budget, shown in Table 6.1 above, can be treated as the lower-bound case unless the economy is hit by either a new global recession or a major cyclone. On the upside, two scenarios provide some sense of the extent to which tax revenue might be raised without necessarily causing capital flight.

- In one scenario, the fiscal-responsibility limit on tax revenue is raised to 30% of GDP, roughly the New Zealand ratio; this would mean that an additional $20 million per year could be raised within the revised ceiling from measures such as those outlined above – enough to replace either capital or current aid grants at the 2016 level, but not both.
- In the second scenario the company tax rate is raised to the New Zealand rate of 28%. This would bring in an additional $15 million of annual revenue if the strong assumptions are made that the economy's growth path would not be affected and that the existing company tax revenue is currently raised at the 20% rate for resident companies. The $15 million figure clearly is an upper-bound estimate of the potential gain on the company-tax front, and before proceeding with such a policy change a careful analysis of the likely impact on private sector growth would be needed. Other specific taxes targeted at room occupancy and sanitation facilities in the tourism sector could provide some top-up on this figure, but the critical constraint would be the reaction of the sector itself to an increased tax burden. (Fijian experience seems to indicate considerable willingness by tourism operators to absorb increased taxes provided that market demand for their services holds up.)

The tax take could of course be further increased by raising the VAT rate, but while tax-efficiency arguments may be made for this, the distributional consequences would probably be counter-productive, given the relationship between the cost of living for resident Cook Islanders and their propensity to relocate to the New Zealand mainland.

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the economic effects of the flights. The crucial issue of whether reducing the subsidy would reduce the flights, and if so by how much, was not addressed. The consultants did note in passing (p.ii) that "[t]he cost of the underwrite is substantial, and requires a significant proportion of government revenue. It is important to recognise that, even though the net effects on the economy are largely positive, the underwrite on this service still represents a very large direct cost to community, and any initiative which can reduce the cost – particularly through marketing and product strategies to generate additional revenue for the air services – will have direct positive effects for the economy and community".

Research into the VAT-elasticity of migration lies outside the terms of reference for this report.

Generally speaking, any attempt to increase the Cook Islands Government's fiscal self-sufficiency has to be targeted at the economic surplus being generated in the tourism sector but currently not being reinvested in the local economy. If $20-25 million extra per year could be raised or saved by any or all of the fiscal measures canvassed above (company tax increase, bed/turnover tax, toilet tax, privatising the cost of the Air New Zealand Underwrite), the outward-flowing surplus would be reduced accordingly and the need to rely on aid would be radically reduced. Only the fear of crowding-out and the sanctity of the fiscal responsibility limits stand in the way, but these are not easily dismissed as trivial obstacles.

7. Other revenue sources

While taxes provide the bulk of Government revenue, other sources of revenue make up around 15%, as shown in Table 7.1. From $18 million in 2012/13 these revenue flows have risen to about $25 million but there seems only limited prospect of future increases. Fisheries revenue, the largest single component, was boosted strongly by reforms and new initiatives in the past decade, but the catch is already pushing ecological limits and region-wide efforts to increase the share of island economies in the total value of the catch in their Exclusive Economic Zones may be running into diminishing returns after early success. The jump in fisheries revenue in the 2015 statistics reflects an increase in the value of a purse-seining fishing day from $2,000 to $10,600; the Cook Islands has 1,250 fishing days per year under the regional quota, which should yield $13 million of revenue on a sustained basis. (The 2015/16 figure of $8.2 million in Table 7.1 appears to be missing $5.8 million of revenue attributable to that year but received after July 1[52].) Dividends come mainly from the Government stake in the local telecommunications monopoly, BlueSky (Telecom), and the Bank of the Cook Islands; no increases are expected in either case. The Airport Authority and the Port Authority do not currently pay dividends. The Port Authority struggles to service a large debt incurred a few years ago for major works at Avatiu; the net revenue stream from the airport comes in the form of about $9 million from departure tax of which $2 million is returned to cover operating costs. The airport has a $48 million set of capital works waiting for non-loan funding. (The Government has not allowed it to proceed with an offered European Investment Bank loan, despite the fact that as an SOE the Airport Authority has notional freedom to raise finance; the issues are that SOE debt is consolidated with other Crown debt for the purposes of the fiscal responsibility ratios, and that the Port loan has highlighted the limited debt-servicing capacity of infrastructure SOEs except for Telecom.) Trading revenue and the "other"

[52] Information from MMR.

revenue at the bottom of the table comprise large numbers of small receipts for government services with no obvious prospects of large increases.

In short, the main opportunities to increase fiscal self-sufficiency lie on the tax front and in the airline underwrite, not in the "other revenue" category, though fisheries should not be overlooked.

Table 7.1: Other revenue

	2012/13	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**	2019/20
Total tax	**97,292**	**97,174**	**100,847**	**111,817**	***109,634***	***111,663***	***114,933***	***117,592***
Other income total	**17,833**	**21,967**	**27,878**	**27,066**	***25,491***	***25,565***	***25,821***	***25,821***
Trading Revenue	5,880	6,357	9,930	8,169	*8,561*	*8,549*	*8,549*	*8,549*
Dividends & interest	3,209	4,582	4,647	4,590	*4,374*	*4,508*	*4,714*	*4,714*
Fisheries revenue	4,196	5,503	11,546	8,087	*10,200*	*10,200*	*10,200*	*10,200*
Other	4,548	5,525	1,755	6,220	*2,356*	*2,308*	*2,358*	*2,358*
Total operating revenue	**115,125**	**119,141**	**128,725**	**138,883**	***135,126***	***137,228***	***140,754***	***143,412***

Sources: June 2014 Quarterly Financial Report p.4 Table 3; 2015/16 Budget Book 1 p.65 Table 7.3.5; 2016/17 Budget Book 1 p.78 Table 7.3.2 and p.80 Tables 7.12 and 7.13. Figures in italics are Budget projections.

8. Aid flows to the Cook Islands

The annual budget documents provide for each year an "Official Development Assistance schedule", which lists in detail the various funding flows that are notified to, and recorded by, MFEM. The ODA funding totals at the bottom of that schedule in the current (2016/17) Budget generally correspond to the "grant" components of revenue reported in the "Government Finance" (GFS) table in the annual Budget[53], but a review of documentation for past Statistics years showed that detailed reconciliation of ODA data with the GFS totals is not straightforward, given that the aid picture is one of constant flux as new projects are added and ongoing projects fall behind schedule with funding carried forward to later years.

Table 4.1 showed grant funding for the Cook Islands Government running at an average of around $20 million annually until 2010, stepping up to around $30 million per year and then with a sharp upward spike to over $40 million in the past two or three years. The level of grant funding classified as "current" remains at around the historic $20 million per year. The increase in the total grant flow is attributable to the sharply increased volume of "capital" grants directed to public-sector investment - both deferred maintenance and the increased infrastructure requirements resulting

[53] Table 4.1 p.16 in the 2016/17 Budget Book 1.

from the growth of the tourism sector and expectations (both locally and from overseas visitors) of higher standards of infrastructure.

In the face of this step change in aid funding, and the change in composition of the total aid package from mainly-current to half-capital, the issue of absorptive capacity has moved into sharp focus. Aid funding until 2010, and the $20-million-odd of current grant funding still flowing, was and is easily absorbed and utilised to support current government operations and low level investment in small and medium-scale projects. The additional tranche of aid inflow since 2010 has been associated with ambitious scheduling of much larger projects that are an order of magnitude more challenging in terms of the need for technical skills, project management and coordination, sophisticated equipment and materials, and resolution of difficult issues around access to land for solar arrays, water intakes, waste disposal sites, and other installations such as the pending undersea cable landing site.

A measure of the short-term absorptive constraints encountered is the aid conversion ratio - the percentage of ODA converted to spending out of the total planned expenditure contracted or pledged by the development partner at the time of the annual budget process. The ratio was calculated as 27% in 2012/13 and 54% in 2013/14[54]. More recent data was not located in the course of this study.

The short-term limits of the local economy's absorptive capacity in the face of this surge in large-scale projects has led to frustrations on both sides, but the view of most people interviewed in the course of this research was that the institutional and engineering issues will be worked through in time[55], and that the current generation of projects will address the most readily-identifiable gaps in infrastructure: water supply, sanitation, cyclone shelters, renewable energy supply, some transport infrastructure issues such as airport runways and road sealing, and (assuming the proposed undersea cable proceeds) broadband and telecoms connectivity. For most of these the required aid funding has been, or will be, committed in advance of the date of possible DAC graduation in late 2017, although the actual spending of the funds will be spread over several years after that date.

The distinction between readily-absorbed current aid flows of around $20 million per year, and the less-easily-absorbed big-project capital grants, points to the need to analyse the implications of DAC graduation separately for each level of aid. Taking the

[54] 2014/15 Budget Book 1 p.141 footnote 13.

[55] Adam Smith International 2015 assessed Cook Islands absorptive capacity on the basis of observed institutional characteristics and concluded that (p.34) "the Cook Islands has significant capacity to absorb more aid in an efficient way, or in other words, investing in Cook Islands through aid will deliver core levels of value for money". However the report acknowledged (p.39) that in relation to the big infrastructure projects in water and sanitation "the capacity of the government to deliver these infrastructure-related activities is limited" and recommended better coordination along with more resources and capacity-building for the key delivery agency Infrastructure Cook Islands (ICI).

detailed flows laid out in the annual "ODA schedule" which appears as Schedule 10 in successive Budget documents, it is possible to distinguish three "tiers" of aid. The top tier comprises the major capital projects[56] with dedicated project-specific funding from donors (supplemented by Cook Islands Government funds drawn from the operating surplus, loan draw-downs, and cash reserves). The second tier is general budget support from New Zealand and the EU, which is injected into the Cook Islands Government budget via MFEM where it is allocated to ministries and agencies according to the budget appropriation process. Finally comes a low-level tier consisting of a myriad of small funding flows secured directly from donors by ministries and agencies, usually on their own initiative, and with the funds not actually passing through MFEM, although they are recorded as appropriations for budgeting purposes. For ease of reference the tiers will be numbered from the bottom up: Tier 1 for the long-running basic flow of small funding tranches, Tier 2 for the general budget support flow that has recently been separated out from Tier 1, and Tier 3 for the big-project capital aid flow.

Tier 3 largely (though not completely) coincides with the "capital grants" revenue figure in the annual Budget. Tier 2, budget support, is current funding for operational activities; and Tier 1, while including some items of apparent capital spending, is mostly current. Table 8.1 assembles figures covering the two fiscal years 2015 and 2016 and the Budget forecasts for 2017, to show the relative weight of the three tiers in the total government budget. Figure 8.1 plots these data.

The very large number of small aid flows in Tier 1 might easily be mis-characterised in terms of the notion of "proliferation" drawn from the international literature, and summarised by Adam Smith International (2015 p.42) in the following terms:

> Proliferation reduces development effectiveness because it increases the burden on partner countries, which have to manage, coordinate and monitor aid contributions. Proliferation also increases the burden on donor agencies, affecting their ability to manage ODA programmes efficiently and also effectively.

To see the Cook Islands Tier 1 aid in these terms would be to miss the central point that these flows are effective precisely because they are small-scale and created on the initiative of, and in response to the direct needs of, the front-line ministries and agencies responsible for delivering services to the Cook Islands community. Many of

[56] For classification purposes the following projects have been included in Tier 3 for the period 2015-2017: Sanitation Upgrade, Te Mato Vai, Apii Nikao construction, Tereora College redevelopment, Renewable Energy Southern Group programme, Atiu Airport upgrade, Outer Island Heavy Machinery and agricultural equipment, Chinese buildings, and the European Investment Bank project at Rarotonga Airport.

those agencies – particularly in education and health - are widely acknowledged to be highly cost-effective in performing their functions[57].

Table 8.1: ODA funding in the total Cook Islands Government budget, NZ$ million

	Actual		Budget projection
Year to June	2015	2016	2017
Tier 3: big capital projects	14.9	11.6	40.4
Tier 2: budget support	5.9	10.8	10.5
Tier 1: small-scale, mostly current, flows	11.6	17.6	17.3
Total grant funding	**32.4**	**40.0**	**68.2**
Capital grants	*22.8*	*19.5*	*23.7*
Current grants	*9.6*	*20.6*	*44.6*
Government total revenue including grants	**160.6**	**178.9**	**203.4**
Government total spending, current and capital	**185.5**	**180.4**	**230.7**
Capital spending	*55.1*	*35.7*	*81.2*
Current spending	*130.5*	*144.7*	*149.5*
Non-ODA funding of total spending	153.1	140.4	162.3

Sources: Tiers 1 and 3 assembled by adding up the relevant row entries in 2015/16 Budget Book 1 p.188-191 Table 16.12 Schedule 10 and 2016/17 Budget Book 1 pp.200-203 Table 16.14 Schedule 10.
Tier 2 data for 2015 from 2015/16 Budget Book 1 p.147-150 Table 15.4, total of tourism support plus education budget support, health specialists visit programme and Social Impact Fund. 2016 is EU budget support plus New Zealand Performance-Based Budget Support plus Social Impact Fund and 2017 from 2016/17 Budget Book 1 pp.200-203 Table 16.14 and p.28 Table 5.6.
Grant funding from 2015/16 Budget Book 1 p.65 Table 7.14 and 2016/17 Budget Book 1 p.16 Table 4.1. The 2015 current grants figure seems low, and the 2017 figure seems high.
Total revenue and total spending from Table 4.1 above. Current and capital spending detail from annual Government financial statements.
Non-ODA funding of spending calculated as a residual; note that in 2015 it includes the drawing-down of $6.5 million from a Chinese Export-Import Bank loan to fund spending on Te Mato Vai.

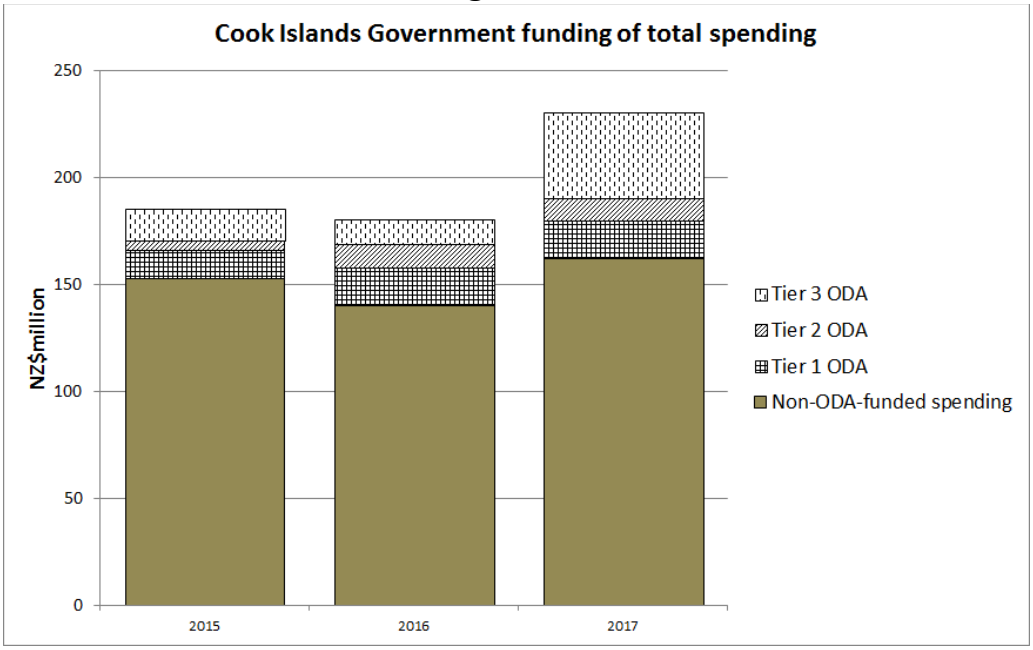
In the course of detailed interviews in August and September 2016 with most of the ministries and agencies that negotiate and utilise Tier 1 funding grants, it became apparent that DAC graduation is not regarded as an issue, with the single possible exception of UNDP and SPC funding for some Ministry of Health (MoH) positions, which was reported to have been cut back recently on the basis of perceived lower need due to increased Cook Islands GDP[58]. Other agencies (Ministry of Marine

[57] E.g. *Public expenditure review of Cook Islands education* April 2013; Adam Smith International 2015; Blattner 2016; Scott 2015; Wilson et al 2013.

[58] In the interview with the Ministry of Health in August 2016 it was reported that UNDP and SPC used to fund scholarships and two paid positions in the Ministry to handle TB and HIV/STIs. The funding was cut a year ago and those positions have disappeared, leaving the programmes unfunded, with the Sexual Reproduction Strategy being shifted to public health staff. UNDP used

Resources and MFEM) with current or expected UNDP funding in the 2016/17 ODA Budget Schedule did not raise any similar concerns about UNDP. UNDP is in any case only 2% of Tier 1 funding in 2016 and 8% in 2017, though its share is expected to rise in future years. UNDP does not appear to have any formal policy with regard to DAC graduation.

Figure 8.1



Source: Table 8.1.

Two other leading players among the 25 Tier 1 donors recorded in the 2016/17 Budget ODA Schedule are the UN Adaptation Fund (UNAF) and the Global Environment Facility (GEF). These account for, respectively, 39% and 15% of the Tier 1 total for 2016/17. Neither of these agencies appears sensitive to DAC graduation, since both have mandates that are focused on environmental rather than income issues. When the direct question was posed to the GEF whether its assistance to the Cook Islands would be affected by graduation, the answer was that[59] "[c]urrent GEF support (STAR allocation) has a component taking into consideration the GDP, but not the income grouping. There are other high income countries that receive support from GEF as well." The same approach seems likely to apply to UNAF.

Other significant Tier 1 donors apart from New Zealand are the Australian Defence Force (ADF) and the EU. The ADF maintains the Cook Islands fisheries patrol vessel and graduation will not affect this (Australia does not record this expenditure as ODA in its DAC statistics[60]). The EU provides $0.5 million of Tier 1 funding for fisheries

to fund two midwifery students to train in Fiji in reproductive/maternity health but this funding was cut and only hard lobbying persuaded UNDP to retain one scholarship position.

59 National Environmental Service email correspondence, 1 September 2016.

60 Information from MFAT.

support, a flow which equally seems unlikely to be sensitive to graduation (note that this funding is not part of the EDF 11 funding controlled by the EU Commission's European Development Fund)[61].

Provisionally, the general conclusion from detailed investigation of Tier 1 aid[62] is that the pending graduation of the Cook Islands from DAC eligibility is effectively irrelevant at that level, apart from about $1 million (4-5% of the Tier 1 total) currently coming from New Zealand under programmes such as Aid Effectiveness, Pacific Maritime Safety, Tertiary Scholarships, and Partnership for Pacific Policing. Whether any of these minor programmes are at risk from DAC graduation has not at this stage been explored with MFAT, but it seems unlikely that there is any major issue here. In any case termination by New Zealand of funding for these and similar small programmes would be easily substituted by technical assistance from other donor sources.

Turning to Tier 2, budget support, more serious issues arise. Of the 2016/17 budget support total of $10-11 million per year, $2.2 million is funded by the EU, and the Cook Islands Government currently budgets on the basis of a cessation of this support after the 2018 fiscal year. It is, however, far from clear that this is the most likely outcome. The 2015 evaluation of the New Zealand aid programme in the Cook Islands made, on a provisional basis, the opposite assumption, and proposed cooperation between New Zealand and the EU in overseeing their budget support operations[63]. That report noted that[64]

> the EU is currently assessing the eligibility of the Cook Islands for budget support financing under its own rules. While the EU budget support guidelines do not require ODA eligibility, income levels matter to decision makers in Brussels. That said, the reason for providing aid is multidimensional in nature and includes development, geopolitical, trade and industry imperatives.

A request to the EU Delegation in Wellington for clarification of the EU stance on graduation elicited the following statement[65]:

> Considering that the negotiations on the post-Cotonou environment have not started yet (they will probably take place in April/May 2017), there is not an overall political context for EU's development policy in relation to the ACP countries. For this reason, we are not in a position at this point to think about country allocations post 2020.

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61 EU Commission 2014 shows EDF11 to be focused on water and sanitation, with no mention of budget support or fisheries. The European Development Fund's €5.3million support for the renewable energy project, via the ADB, was negotiated separately; see http://ec.europa.eu/europeaid/projects/solar-photovoltaic-power-generation-capacity-cook-islands_en .

62 Note that the conclusion drawn here is based on the views of CIG informants engaged in securing funding from international donors, rather than on responses fromn the donors themselves. Only GEF and EU were approached directly with questions about their attitudes to graduation.

63 Adam Smith International 2015 p.24 footnote 35.

64 Adam Smith International 2015 pp.78-79.

65 Email from Nikolas Evangelides, EU Delegation Wellington, 26 September 2016.

> Regarding Cook Islands, for the 2017-2021 period we can say that the EU will not change its approach. We are currently operating under EDF 11 which goes up to 2020. Depending on the details of the new programme with Cook Islands on [Water Sanitation and Hygiene], implementation might go slightly beyond 2020.

There is therefore no formal position, and no certainty, regarding EU policy towards the Cook Islands after 2021. There appears to be no formal agreement in place regarding EU budget support beyond 2018. The approach taken in the 2016/17 Cook Islands Budget, which assumes cessation of EU budget support beyond 2018, while justifiable, seems conservative. In any case the potential loss of $2 million of annual revenue does not on its own present a serious fiscal challenge, especially if the recent upward path of tax revenue is sustained.

Clearly more serious would be cessation of New Zealand's budget support, currently running (in terms of the Cook Islands Budget documents[66]) at $8.3 million per year (including the Social Impact Fund). The 2015 country programme evaluation made the strong recommendation that "in recognition of the special relationship between New Zealand and the Cook Islands, financial assistance should be kept at current real levels, irrespective of ODA eligibility status"[67], and MFAT has advised that while no political decision has been taken to extend this support beyond the end of the current triennium in 2018, the present study should proceed on the assumption that budget support will continue beyond that date, presumably at the current level of around $8-10 million annually. On that basis, DAC graduation is here assumed not to affect the New Zealand component of Tier 2 aid, leaving only the $2 million of EU funding possibly at risk.

Turning finally to Tier 3, the large-scale capital-works funding, the present cohort of large projects is expected to have funding committed prior to DAC graduation, though the actual expenditure of these funds will extend beyond 2020. From the Cook Islands point of view, therefore, graduation presents a problem only for the capital works programme beyond 2020. Section 9 below turns to the scale of those future public-sector investments.

Table 8.2 shows the breakdown of grant-aid funding by tier and by individual donor for the three years 2014/15, 2015/16 and 2016/17. The category "DAC-reportable donors" in this table includes all international agencies in respect of which contributions to those agencies from DAC member states can be credited as "ODA" in the DAC statistics for those member states.

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66 Adam Smith International 2015 pp.21-22 reports a larger figure of $10 million p.a. for New Zealand budget support.

67 Adam Smith International 2015 p.79.

Table 8.2: Aid to CIG by donor and tier, NZ$ million

	2014/15 actual				2015/16 actual				2016/17 budget				Donor report-able to DAC y/n
	Tier 1	Tier 2	Tier 3	**Total**	Tier 1	Tier 2	Tier 3	**Total**	Tier 1	Tier 2	Tier 3	**Total**	
European Union	0.77	0.00	0.00	**0.77**	1.81	2.21	7.51	**11.52**	1.21	2.21	8.98	**12.40**	y
New Zealand	1.60	5.92	5.07	**12.58**	0.87	8.62	3.90	**13.39**	1.11	8.30	20.47	**29.88**	y
China	0.00	0.00	9.12	**9.12**	1.24	0.00	0.00	**1.24**	0.00	0.00	4.97	**4.97**	n
Japan	0.00	0.00	0.00	**0.00**	5.41	0.00	0.00	**5.41**	0.56	0.00	0.00	**0.56**	y
Global Environment Facility	0.64	0.00	0.00	**0.64**	1.85	0.00	0.18	**2.04**	3.84	0.00	5.52	**9.36**	y
Asian Development Bank	0.69	0.00	0.00	**0.69**	1.71	0.00	0.00	**1.71**	1.31	0.00	0.00	**1.31**	y
UN Adaptation Fund	0.39	0.00	0.00	**0.39**	1.41	0.00	0.00	**1.41**	3.66	0.00	0.00	**3.66**	n
FAO	0.00	0.00	0.00	**0.00**	0.57	0.00	0.00	**0.57**	0.44	0.00	0.00	**0.44**	y
European Investment Bank	0.22	0.00	0.00	**0.22**	0.00	0.00	0.00	**0.00**	0.00	0.00	0.51	**0.51**	y
India	0.11	0.00	0.00	**0.11**	0.30	0.00	0.00	**0.30**	0.62	0.00	0.00	**0.62**	n
Korea	0.00	0.00	0.00	**0.00**	0.40	0.00	0.00	**0.40**	0.31	0.00	0.00	**0.31**	y
WHO	0.00	0.00	0.00	**0.00**	0.20	0.00	0.00	**0.20**	0.33	0.00	0.00	**0.33**	y
Forum Fisheries Agency	0.04	0.00	0.00	**0.04**	0.37	0.00	0.00	**0.37**	0.27	0.00	0.00	**0.27**	y
Australia	0.09	0.00	0.00	**0.09**	0.31	0.00	0.00	**0.31**	0.10	0.00	0.00	**0.10**	y
Australia Defence Force	6.76	0.00	0.00	**6.76**	0.30	0.00	0.00	**0.30**	1.10	0.00	0.00	**1.10**	n
UNDP	0.00	0.00	0.00	**0.00**	0.22	0.00	0.00	**0.22**	1.34	0.00	0.00	**1.34**	y
Secretariat of the Pacific Community	0.00	0.00	0.00	**0.00**	0.16	0.00	0.00	**0.16**	0.20	0.00	0.00	**0.20**	y
UNFPA	0.03	0.00	0.00	**0.03**	0.11	0.00	0.00	**0.11**	0.00	0.00	0.00	**0.00**	y
Multilateral Fund	0.08	0.00	0.00	**0.08**	0.08	0.00	0.00	**0.08**	0.12	0.00	0.00	**0.12**	y
Commonwealth Secretariat	0.08	0.00	0.00	**0.08**	0.07	0.00	0.00	**0.07**	0.07	0.00	0.00	**0.07**	y
UNESCO	0.09	0.00	0.00	**0.09**	0.10	0.00	0.00	**0.10**	0.15	0.00	0.00	**0.15**	y
Western Pacific Council (US)	0.00	0.00	0.00	**0.00**	0.07	0.00	0.00	**0.07**	0.04	0.00	0.00	**0.04**	n
EU-German Devpt Cooperation	0.00	0.00	0.00	**0.00**	0.00	0.00	0.00	**0.00**	0.21	0.00	0.00	**0.21**	y
Green Climate Fund	0.00	0.00	0.00	**0.00**	0.04	0.00	0.00	**0.04**	0.30	0.00	0.00	**0.30**	y
SSCSIP	0.00	0.00	0.00	**0.00**	0.00	0.00	0.00	**0.00**	0.01	0.00	0.00	**0.01**	n
Thailand	0.00	0.00	0.00	**0.00**	0.01	0.00	0.00	**0.01**	0.00	0.00	0.00	**0.00**	n
SIDS-DOCK	0.00	0.00	0.71	**0.71**	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	n
UNEP	0.03	0.00	0.00	**0.03**	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	y
Totals	**11.61**	**5.92**	**14.90**	**32.43**	**17.62**	**10.83**	**11.59**	**40.04**	**17.29**	**10.50**	**40.44**	**68.24**	
Total from DAC member states	2.46	5.92	5.07	13.44	8.81	10.83	11.41	31.04	3.50	10.50	29.45	43.45	
Total from DAC-recognised multilateral agencies	1.89	0.00	0.00	1.89	5.48	0.00	0.18	5.66	8.37	0.00	6.03	14.40	
Total from non-DAC-recognised donors	7.26	0.00	9.83	17.09	3.33	0.00	0.00	3.33	5.42	0.00	4.97	10.38	

Sources: Figures assembled from 2015/16 Budget Book 1 Table 16.12 pp.188-191 and 2016/17 Budget Book 1 Table 16.14 pp.200-203. DAC-reportable institutional donors identified from lists at http://www.oecd.org/dac/financing-sustainable-development/development-finance-standards/annex2.htm.

The central issue addressed in this report is the effect that graduation might have on flows of assistance to the Cook Islands, which depends on the motivations driving assistance from each donor. The research for this report found no clear evidence that any of the multilateral agencies active in the Cook Islands, whether DAC-recognised or not, is likely to react to graduation by cutting off assistance. At most there could be minor adjustments at the margin (for example to UNDP/SPC medical scholarships). The potential impact of graduation hinges therefore on the reactions of the five DAC member states listed in Table 8.2: New Zealand, Australia, EU, Japan, and Korea. Table 8.3 summarises the proportions of aid to the Cook Islands sourced from DAC member states, DAC-recognised multilateral agencies, and other donors unrelated to DAC.

Table 8.3: Aid to CIG by donor category

	2014/15	2015/16	2016/17
Tier 1: Small-scale decentralised grants			
1. From DAC member states NZ$m	2.5	8.8	3.5
2. From DAC-recognised multilateral agencies NZ$m	1.9	5.5	8.4
3. From non-DAC-recognised donors NZ$m	7.3	3.3	5.4
4. Non-graduation sensitive, 2+3, NZ$m	9.2	8.8	13.8
5. Non-graduation sensitive %	79%	50%	80%
Tier 2: Budget support			
1. From DAC member states NZ$m	5.9	10.8	10.5
2. From DAC-recognised multilateral agencies NZ$m	0.0	0.0	0.0
3. From non-DAC-recognised donors NZ$m	0.0	0.0	0.0
4. Non-graduation sensitive, 2+3, NZ$m	0.0	0.0	0.0
5. Non-graduation sensitive %	0%	0%	0%
Tier 3: large capital grants			
1. From DAC member states NZ$m	5.1	11.4	29.4
2. From DAC-recognised multilateral agencies NZ$m	0.0	0.2	6.0
3. From non-DAC-recognised donors NZ$m	9.8	0.0	5.0
4. Non-graduation sensitive, 2+3, NZ$m	9.8	0.2	11.0
5. Non-graduation sensitive %	66%	2%	27%
Total			
1. From DAC member states NZ$m	13.4	31.0	43.5
2. From DAC-recognised multilateral agencies NZ$m	1.9	5.7	14.4
3. From non-DAC-recognised donors NZ$m	17.1	3.3	10.4
4. Non-graduation sensitive, 2+3, NZ$m	19.0	9.0	24.8
5. Non-graduation sensitive %	59%	22%	36%

Source: Table 8.2

Clearly there is a differential potential impact of graduation across the three tiers. Tier 1 is threatened only marginally if at all; Tier 2 is entirely from DAC member states and hence is potentially all at risk (depending basically on policy decisions by New Zealand); and Tier 3 shows a picture that swings from year to year depending on which

particular donors and projects happen to prevail, with non-sensitive donors ranging from 20 to 60% of the aid flow over the three years covered by the table.

One important category of assistance is missing from the Tier 1 numbers above but would need to be brought back in for a complete analysis. This is the unrecorded value of assistance in kind that is accessed by the Cook Islands through, for example, free access to the New Zealand health and education systems, fisheries surveillance flights by Australia, France and New Zealand, and the regional monitoring and regulatory systems which exist to ensure maintenance of aviation and maritime safety standards. In both health and education, the Cook Islands Government is relieved of the cost of providing or purchasing tertiary levels of service, because Cook Islanders as New Zealand citizens are able to access directly the health and education systems in New Zealand.

For example, MOH statistics show an average of around 150-200 patients per year referred to NZ for health services including cancer treatment, dialysis, CT Scans, surgery, and mental health. The cost of treatment of Cook Islanders in New Zealand is not separately reported by the District Health Boards.

As there are no data on the financial value of these fiscal savings, they are excluded from the present analysis, but their exclusion needs to be borne in mind when interpreting the results. DAC graduation does not appear likely to have any effect on any of them.

9. The future capital programme

The Cook Islands' infrastructure needs have been laid out most recently in the 2015 National Infrastructure Investment Plan (Cook Islands Government 2015)[68]. The Plan describes a prioritisation process that started by weeding out lower-priority programmes from a list of 80, reducing the candidates to 43. Further prioritisation brought the list down to 33 projects of which 9 were already underway (and apparently already funded from donors or local sources) at the time of the Plan[69]:

[68] Infrastructure needs and plans are discussed in ADB 2015, pp.46-51 and Appendix 4 pp.67-73.

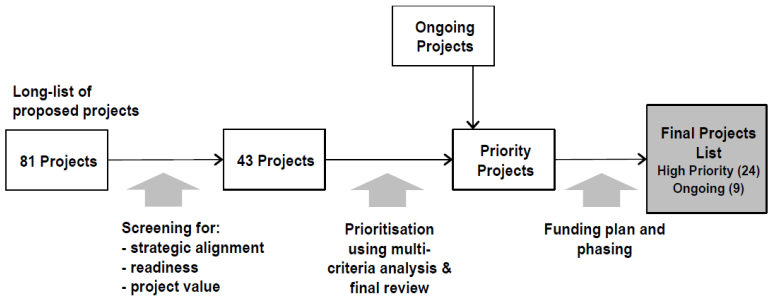
[69] Diagram from Cook Islands Government 2015 p.2.

Table 9.1: National Infrastructure Investment Plan Priority Projects as at 2015

Sub-sector	Project	2015 Estimate of cost NZ$ million	Spending lined up as at 2016/17 Budget	2015 estimate of timing
Air transport	Rarotonga Airport Terminal Improvement	9.3	0.0	2024
	Rarotonga Airport instrument landing system upgrade	3.2	0.0	2016-2018
	Atiu Airport sealing and upgrade to CAA certification (Part 139)	3.9	3.9	2017-2019
Marine transport	Aitutaki, Orongo Marina and Town Centre Development	15	1.1	2017-2020
	Penrhyn Coastal Protection – Te Tautua and Omoka Port Facilities and Fuel Depot	4	0.3	2015-2017
Road transport	Avarua bridges	5	2.1	2021-2023
	Bridges upgrade including Avatiu Valley bridge	1.5	0.4	2016-2018
	Road sealing Aitutaki	0.8		2018
Water supply	Te Mato Vai – Trunk, Intakes, Reservoirs, Treatment, Meters etc.	36.3	53.2	2014-2018
	Outer Islands Community Water Tank Rehabilitation	1.5	0.8	2014-2016
Sanitation	Rarotonga long-term sanitation upgrade	37	15.1	2024
Solid waste management	Incinerator for Rarotonga	3		2021
Energy	TAU control & Generation - Rarotonga	45.2	26.7	2016-2023
	Aitutaki Solar PV Mini-Grid System	16		2015-2017
	Atiu Solar PV Mini-Grid System	3.1	6.5	2014-2016
	Mauke Solar PV Mini-Grid System, and generators, powerhouse, distribution upgrade	3.2		2014-2016
	Mitiaro Solar PV Mini-Grid System	1.9		2014-2016
	Mangaia Solar PV Mini-Grid System	3.5		2014-2016
ICT	Fibre-optic Cable for international communications	35		2019-2021
Multi-sector	Rutaki Foreshore Rock Revetment	2.6	0.1	2017-2019
	Outer islands cyclone shelters	2	1.2	2016-2018
Education	Apii Nikao School Reconstruction	11.4	15.3	2014-2017
	Re-build National College (Tereora)	30	11.5	2018-2023
	Fitting Schools with Water Harvesting Systems (pilot)	0.5		2016-2017
Totals		**274.9**	**138.2**	

Source: Cook Islands Government 2015 p.xiv Table ES.6; 2016/17 Budget Book 3.

Figure ES.1 Project Identification and Prioritisation Process



The 24 new projects were costed in 2015 at a total of $275 million in the table reproduced as Table 9.1 above. Of these, 45% of the projects by number and 35% by value were greenfields projects; the rest involved refurbishment or upgrading of existing infrastructure that had been allowed to run down[70].

Of the $275 million cost of the prioritised projects, the 2015 Plan anticipated that $50 million would come from Cook Islands Government funding, $180 million from ODA grants, $28 million from loans, and $30 million from SOEs and private sector participants in the fibre-optic cable, electricity system, Manihiki harbour, and Rarotonga Airport improvements. The great bulk of the priority spending was to be in Rarotonga and Aitutaki, with Outer Island projects whittled down to $1.5 million for water tanks and $2 million for cyclone shelters.

While the timetable laid out in the projects list was optimistic, the progress made since the Plan was written, in terms of securing funding for projects, is impressive. According to the Capital Plan in Book 3 of the current 2016/17 Budget, about half of the funding originally estimated to be required is now committed and budgeted for, while the fibre-optic cable, the Rarotonga and Southern Group electricity programme, and an enhanced version of the sanitation upgrade, are all moving forward in terms of funding.

In its Chapter 5, the 2015 Infrastructure Investment Plan reviewed in some detail the potential funding sources that might enable the priority projects list to be carried through over a decade. Overseas borrowing was assumed to be limited to $13.2 million from ADB for the renewable energy project, and the drawing-down of a $14.8 million Chinese loan for the Te Mato Vai ring-main, which would keep debt comfortably below the prudential ceiling of 35% of GDP, with headroom for emergency borrowing to fund reconstruction in the event of a major cyclone event. The Cook Islands Government was expected to fund $5 million per year, SOEs about $1 million the private sector possibly $2 million, and ODA the remaining $18 million[71]. Experience to date suggests that the Government and ODA expectations have been

[70] Cook Islands Government 2015 p.xv; 2017/17 Budget Book 3.

[71] Cook Islands Government 2015 p.53 Table 5.1.

exceeded while the private sector and SOEs have not figured in funding commitments to this point. It does seem, however, that the Cook Islands is well on the way to pushing through the priority infrastructure investment planned for in 2015.

Comparing the Capital Plan in Book 3 of the 2016/17 Budget with the "next 19" projects listed in the 2015 Plan's Table ES.5, it seems that there is also significant progress towards implementing a number of these as well.

Further down the track, however, it is not difficult to see an ongoing need for external grant funding to maintain the momentum of infrastructure development. The "long list" from which the 2015 Plan's prioritisation process eliminated 48 projects (set out on pages 33-35 of the 2015 Plan) contains candidates for future implementation, and pointers to more. (Solid waste disposal, for example, seems to need more than simply the incinerator included in the final Infrastructure Investment Plan.) The Rarotonga Airport in April 2016 submitted to the Cook Islands Investment Corporation (CIIC) a list of $48.8 million of desirable investments in the airport, with a proposal to raise a $20 million loan from the European Investment Bank and $10 million of ODA grant funding; the proposal was turned down by the Government, largely because of the perceived need not to endanger the prudential debt ceiling.

Clearly so long as large-scale borrowing is off the agenda, and so long as the Cook Islands Government achieves only a marginal operating surplus on average even with budget support taken into account, external capital aid funding will remain essential for improving and maintaining public infrastructure. This does not, however, necessarily imply that aid funding has to continue at the levels seen in the past few years, once the current bulge of major projects has been worked through. A lower level of capital grant aid, possibly less than the $10 million per year foreshadowed in the 2015 Plan, would probably suffice – especially if the fiscal options discussed elsewhere in this report were to be explored.

Such a level of ongoing aid seems well within the bounds of feasibility in a post-graduation setting. There are good grounds to expect that if and when graduation-sensitive DAC donors such as the EU and Japan exit, their place can and will be filled by other donors – whether non-DAC donors such as China and India, or international agencies such as the GEF and UNAF, or both. Obviously, though, the first question to ask is how principal donor, New Zealand, will react to DAC graduation.

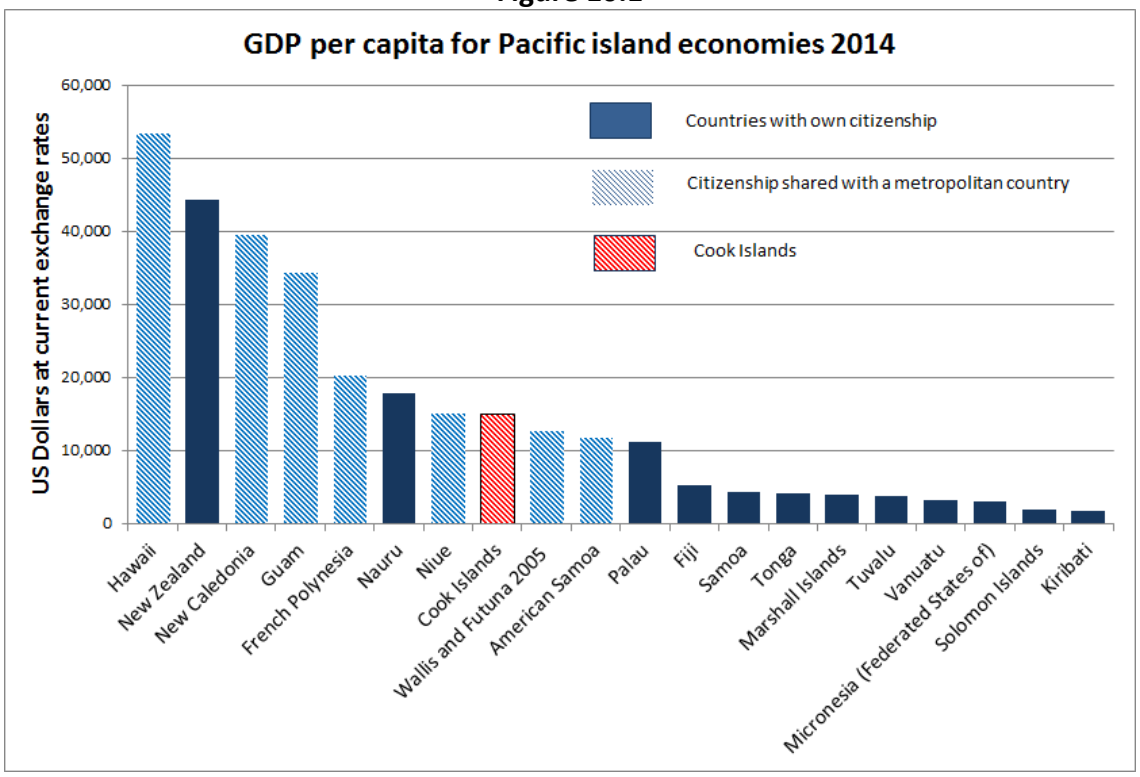
10. Implications of DAC graduation

The analysis in this report has led to the clear conclusion that DAC graduation in and of itself has no major financial implications for the Cook Islands provided that New Zealand does not withdraw its support. The political and constitutional issues surrounding the relationship between New Zealand and the Cook Islands lie outside

the terms of reference for this project, but the economics of "self-government in free association" are relevant.

The Cook Islands is one of a number of small island economies whose inhabitants share the citizenship of a metropolitan partner country. Statistically, such shared citizenship arrangements are a strong predictor of relatively high income levels and good Human Development Index scores[72]. Conventional analyses often compare the Cook Islands favourably with a sample of sovereign Pacific island countries that lack shared citizenship arrangements[73], but these comparisons provide an incomplete picture because they exclude the region's island economies built around shared citizenship arrangements – French Polynesia, Wallis and Futuna, American Samoa, Norfolk Island, Chatham Islands, Guam, Hawai'i, New Caledonia, Rapanui/Easter Island. As Figure 10.1 shows, relative to these comparators the Cook Islands falls in the middle of the sample alongside neighbouring French Polynesia, in terms of GDP per capita.

Figure 10.1



Sources: Most from United Nations National Accounts statistics at http://unstats.un.org/unsd/snaama/Introduction.asp.
Hawaii, Guam and American Samoa from https://www.bea.gov/regional/bearfacts/action.cfm.
Niue from https://dfat.gov.au/trade/resources/Documents/niue.pdf.
Wallis and Futuna from https://en.wikipedia.org/wiki/Economy_of_Wallis_and_Futuna.

[72] Armstrong and Read 2000; Bertram 2004, 2015; Feyrer and Sacerdote 2009; McElroy and Pearce 2006; Sampson 2005.

[73] For example ADB 2015 p.2 and Figure 1, ADB 2008, Adam Smith International 2015, and the 2016/17 Cook Islands Budget p.42.

Notwithstanding their relatively high incomes, all of the shared-citizenship economies in Figure 10.1 remain reliant on financial transfers from the metropolitan economies whose citizenship they share, and it seems likely that the same will apply to the Cook Islands after DAC graduation.

Local governments in New Zealand face very similar issues to those which concern the Cook Islands Government: their limited ability to mobilise resources from their local economies via rates, levies, sales of goods and services and so on falls short of what is needed to meet the infrastructural investment needs of the community, and reliance is placed on Wellington to provide grant funding. In Auckland and Wellington cities the central issue is transport; in Christchurch it is recovery from a natural disaster; in Rarotonga it is water supply, sanitation, energy, and a raft of deferred maintenance. In terms of economic analysis the Cook Islands Government is better thought of as a special case of New Zealand local/regional government than as another sovereign state like Tuvalu, Fiji, Kiribati, Tonga or Samoa.

For some decades now, New Zealand financial assistance to the Cook Islands Government has been categorised as "ODA" and has been included in New Zealand's DAC statistics along with assistance provided to a wide range of other states, most of them fully independent ones. The original decision to classify as ODA, and hence subject to the DAC rules, the financial assistance that New Zealand provides to the small islands that share New Zealand citizenship within the Realm of New Zealand was taken many decades ago.

Within the overarching constraint of shared citizenship and the related labour mobility, the Cook Islands Government can increase its self-reliance only by capturing a greater share of the substantial operating surplus now being generated in the tourism sector. This would involve breaking out of the limit on tax revenue in the 1998 Manila agreement. (There is no case currently for relaxing the debt ceiling of 35% of GDP; whereas tax revenue contributes to self-sufficiency, increased indebtedness does the opposite.) Such a process of diverting the flow of surplus that currently flows out of the local economy, and utilising that surplus to fund the local infrastructure on which the prosperity of the tourism sector depends, would at some point run into diminishing returns as offshore investors turned to other opportunities in other locations. But over some range of public-sector expansion the two sectors' complementarity could be expected to produce joint benefits. It is unknown whether the tax rate required to fund infrastructure investment entirely from local sources could be consistent with continued success of the tourism-led economy. The Cook Islands Government and the local private sector therefore have a strong shared interest in continued grant funding from offshore, and the New Zealand Government arguably shares that interest.

Aid to the Cook Islands functions as a means of keeping the Cook Islands Government small enough to clear space for the private sector to flourish, while limiting the

voluntary relocation of resident Cook Islanders to New Zealand. The collateral consequences of cutting off New Zealand assistance are probably sufficient to justify ongoing official assistance, and hence to prevent DAC graduation becoming a problem for CIG fiscal management.

Were a withdrawal of New Zealand aid after 2018 to occur, the long term effects would be most significant in relation to budget support. Taking separately the three "tiers" of aid shown in Table 8.2 above, the following points can be made:

- Tier 1 aid from all sources to the Cook Islands, comprising over 70 individual projects (technical assistance, scholarships, subsidies, small investment grants) mostly well below $1 million[74], amounted to $11.6 million in 2014/15, $17.6 million in 2015/16, and a projected $17.3 million in 2016/17. Of these sums New Zealand provided respectively $1.6 million (14%), $0.9 million (5%), and $1.1 million (6%). New Zealand's withdrawal from Tier 1 assistance, therefore, would have only minimal impact in financial terms; other donors would almost certainly be found to replace most or all of New Zealand's $1 million-odd of funding. There would obviously be qualitative changes in the nature of technical assistance delivered in programmes such as public service strengthening, maritime safety and Pacific policing, if those programmes were funded and staffed by donors other than New Zealand.

- Tier 2 aid (budget support) rose sharply from $6 million in 2014/15 to $10-11 million from 2015/16 on, with New Zealand as the dominant donor, contributing $8.6 million in 2015/16 and $8.3 million in 2016/17. These sums represent just under 2% of Cook Islands GDP and 5-6% of the CIG's current spending. Withdrawal by New Zealand of this flow of funding would require adjustment of CIG fiscal policy. Options would include an increase in tax revenue, a reduction in government services, and some reallocation of government resources from the capital programme to maintain current spending levels. Section 6 above suggested that either raising the company tax rate, or privatising/eliminating the Air New Zealand subsidy, could provide additional fiscal resources on a sufficient scale to substitute for New Zealand budget support.

  The option of cutting back CIG capital spending in response to a loss of budget support would be problematic, given that once the CIG's presently high level of capital expenditure out of cash reserves and loan draw-downs comes to an end after 2019, the CIG capital works budget is projected to be less than $6 million

[74] Programmes over the $1 million mark have been the Australian Defence Force's support for the Te Kukupa patrol vessel, the Global Environment Facility's Ridge to Reef project, and the UN Adaptation Fund's Strengthening Resilience progtamme.

per annum[75]. Failure to maintain at least this level of capital expenditure would cause infrastructure (and hence services) to degrade again, as happened in the decade before 2010.

Whichever fiscal policy response was pursued, the general effect would be the same: the loss of budget support would pass through to the private sector, whether through reduced public services or increased taxes. At less than 2% of GDP the shock would not be major, but could be sufficient to give some added impetus to depopulation.

- Tier 3 aid (large-project capital spending) is presently running temporarily at an historically high level, with New Zealand contributing between one third and one half of the total. As the current generation of projects are completed in the early 2020s, both the total aid flow and the New Zealand component of it are expected to drop steeply, regardless of DAC graduation. A New Zealand withdrawal from providing new capital grants post-graduation would force the CIG to curtail its future capital programme relative to what would be possible with continued New Zealand support, with future development options increasingly dependent on China, India, international agency donors, and other non-DAC sources of finance.

In summary, withdrawal of New Zealand aid would squeeze the CIG current budget by $8-9 million per year (about 2% of GDP) which would have to be made up in some way. In terms of capital works a New Zealand withdrawal would restrict the scale of future investments insofar as non-DAC donors did not fill the gap by raising their contributions to the Cook Islands.

The question of how New Zealand should react to Cook Islands graduation from ODA status was addressed directly in the 2015 country programme evaluation in terms that are fully consistent with the findings in the present study:[76]

> Financial assistance could … still be classified as 'Official Aid', which is the same as the ODA definition without the requirement to be on the OECD-DAC List of ODA Recipients. In this context donors need to establish their own guidelines for the provision of 'official aid', which we suggest New Zealand needs to attend to … [T]he reason for providing aid is multidimensional in nature and includes development, geopolitical, trade and industry imperatives. The strengthening relationship between the Cook Islands and China will be an important factor influencing the levels and types of financial assistance New Zealand provides to the Cook Islands. The new China engagement model developed by the Cook Islands will also be important for OECD donors moving forward with their engagement strategies with China. The Realm state relationship between New

[75] 2016/17 Budget Book 3 Table 1 p.3 and Table 2 pp.4-6.

[76] Adam Smith International 2015 pp.78-79.

> Zealand and the Cook Islands is the dominant factor underpinning New Zealand's policy decisions, and its official aid guidelines should be developed with reference to that relationship…
>
> In recognition of the special relationship between New Zealand and the Cook Islands, financial assistance should be kept at current real levels, irrespective of ODA eligibility status. There still remains much work to be done to help the Cook Islands become more economically resilient and improve its service delivery standards. The existing strong relationships between New Zealand and Cook Islands' government agencies and civil society actors present clear opportunities for strengthening New Zealand's whole-of-country approach. The Cook Islands also faces many economic challenges going forward and noting the fluid labour mobility between the two countries, it is in both New Zealand and the Cook Islands' interest to ensure that development achievements remain high to halt depopulation and forge a sustainable economy.

11. Conclusions

Two central conclusions have emerged from this review of the possible implications of DAC graduation for the Cook Islands.

- The first is that there is an immediate need to strengthen the Cook Islands national accounts, with particular emphasis on (i) producing more comprehensive balance of payments statistics, with special attention paid to the primary and secondary income components of the current account; (ii) constructing a Tourism Satellite Account to trace more accurately the factor incomes being generated in the core of the economy's private sector; and (iii) producing an authoritative figure for GNI per capita, with a view to finding out whether graduation from the DAC system may be premature because of reliance on the per capita GDP statistic.
- The second is that DAC graduation *per se* has very limited implications for the Cook Islands, and quite possibly none, provided that New Zealand (the main DAC donor) does not withdraw its support. Up to half of the economy's ODA now comes from sources that appear insensitive to DAC graduation, and this seems likely to increase in future, especially with the rising donor profile of China and of international climate change agencies such as GEF. Of the funding from DAC member states, the large sums currently flowing from the EU will drop steeply in any case as the infrastructure projects they support are completed, and the EU's longer-run role seems likely to be a minor one, comparable to the ADB's 4% of the ODA grant flow, regardless of the graduation issue. The only serious long-run uncertainty is the position of New Zealand, the lead DAC donor, which has not been formally articulated but is unlikely to involve severance of the aid relationship. It would nevertheless be

helpful for New Zealand's longer-term intentions to be clarified, to enable the Cook Islands to plan its fiscal management in a post-DAC aid environment.

In terms of specific issues to be addressed under the terms of reference, the following detailed conclusions have been reached:

1. ***Assess what the implications of ODA graduation may be for the Cook Islands, in terms of accessing financial and technical support.***

Tier 1 grant aid amounting to roughly $20 million per year is sourced from a wide range of donors most of which are unconcerned with the issue of DAC graduation; this aid will continue. Tier 2 aid - budget support - is not explicitly guaranteed to continue beyond 2018, but neither is it explicitly guaranteed to be discontinued; a reasonable response to this uncertainty is for the Cook Islands Government to establish a buffer-fund arrangement of some sort. Tier 3 - capital grant aid - seems likely to secure committed funding for the key infrastructure projects within the graduation window. Ongoing capital investment needs beyond 2021 will be less, and potentially within the fiscal capacity of the Cook Islands Government if its limit on tax revenue-raising is relaxed somewhat and its non-DAC donors continue their support.

2. ***Assess whether a loss of ODA support to the Cook Islands could cause economic set backs, and what these setbacks might be.***

It is generally agreed that ODA has raised and sustained living standards in the Cook Islands, and that its withdrawal would cause downward pressure on living standards. The detailed effects, however, would not be those to be expected in an economy without the shared citizenship and common currency that provide the adjustment mechanisms in the Cook Islands. The resident population retains always the fallback option of moving to New Zealand if jobs and incomes fall, and the Cook Islands Government has options to increase its revenues sufficiently to sustain its finances without aid if the fiscal-responsibility limit on its tax take is eased. The main negative effect of an aid cut-off would probably be felt by the private tourism sector as its present low-tax environment came to an end.

3. ***Assess whether graduation could result in a project or service delivery shortfall within the Cook Islands economy***

The capital works programme laid out in the 2015 Infrastructure Plan seems likely to have attracted the great bulk of its required external funding before the likely graduation date; in any case a number of non-DAC donors with funding capacity far greater than the Cook Islands' requirements are increasingly active on this front and will be unaffected by DAC graduation. A wide range of country and agency donors provide small-scale (Tier 1) aid directly to front-line government agencies and are almost all insensitive to the DAC graduation issue. The primary threat is to the Government's operating spending if there is a drop in budget support grants, but these now make up less than 10% of Government operating revenue and their

disappearance could be fully compensated for by, for example, an increase in the company tax rate from its present 20%, or cessation/privatisation of the annual subsidy paid to Air New Zealand.

4. ***Assess, post-graduation, whether the Cook Island's cost of borrowing will increase (if concessional lending terms become less available), and whether perceptions of the Cook Island's debt servicing capability are likely to change***

The cost of borrowing is irrelevant. The Cook Islands already has access to more loan finance than it can use within its fiscal-responsibility debt ceiling, which requires it to keep net debt below 35% of GDP with a substantial margin to provide a buffer in the event of a major cyclone disaster. Cost is not a constraint on borrowing and debt service is fully manageable so long as the debt ceiling holds. Relaxing that ceiling does not seem a wise move.

5. ***Identify key revenue risks and opportunities (e.g. limited resources, reliance on tourism, debt burden, and climate change finance and New Zealand assistance***

Limited resources arise as an issue only in the context of crowding-out. Donors such as ADB have operated on the basis of a crowding-out model that may not be sufficiently attuned to the particular circumstances of a shared-citizenship economy. There would seem to be untapped revenue potential in the reported balance of payments surplus, which implies large outward movement of funds some of which could potentially be captured for public-sector use. There appears to be no solid research on the question of whether there is a serious crowding-out risk in the Cook Islands; the most obvious effect of this sort is actually the crowding-in effect of government spending, insofar as it forestalls some depopulation that would otherwise have occurred. Increased revenue from taxes, if the tax ceiling can be relaxed, would assist with fiscal self sufficiency. Increased indebtedness would do the opposite; there is no obvious case for relaxing the debt ceiling.

6. ***Recommend policy / legislation options for mitigating risks and maximising opportunities (e.g. tax reform, sovereign wealth funds etc.)***

There is a need for some buffering arrangement to mitigate the risk to budget support that results from New Zealand's stop-start three-yearly approach to budget support, as well as to address the volatility of other funding sources. A well-fenced-off trust fund of some sort would be appropriate. An obvious change that would relieve fiscal pressure would be privatisation of the Air New Zealand subsidy arrangement, or any other arrangement that enables its cost to be recovered directly from the tourism sector that is the primary beneficiary of the subsidy; this ought to be the first option considered in any move towards user-pays arrangements for public services. The company tax rate is low relative to that in New Zealand and consideration could be given to raising it.

7. Consider options and recommendations for a 'smooth transition' that minimises disruption to the economy

Because the most likely outcome of DAC graduation for the Cook Islands is a negligible fiscal impact, the transition should be a painless one. The most important adjustments would be those required at the New Zealand end, in terms of what financial assistance would continue to be made available, and through which channels, once the DAC umbrella is removed.

8. Consider any other economic analysis and assessment of implications and consequences of potential graduation

The most important analytical distinction to be made is that between fully-independent economies such as those against which the Cook Islands is most commonly ranked, and those with shared citizenship and correspondingly tight economic integration with a metropolitan partner economy. DAC graduation for the Cook Islands will mean that New Zealand assistance to the CIG will no longer be counted in the DAC league tables, but this has no necessary implications for either the amount or the nature of that assistance.

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